The New York Certified Public Accountant

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Managing Editor

The NEW YORK CERTIFIED PUBLIC ACCOUNTANT *is published monthly from October to June. Copies may be obtained at the office of the Society at twenty-five cents per copy, $2.00 per year. All other communications relating to this publication should be addressed to the Committee on Publications.*

STATE SOCIETY ACTIVITIES

Calendar of Events

March 17—Regular Meeting of the Board of Directors.

March 17—7:45 P.M.—Society Meeting—Subject: Appraisals as Related to Accounting. Location: Waldorf-Astoria Hotel, Lexington Avenue at 49th Street, New York City.

April 9—Regular Meeting of the Board of Directors.

April 14—7:45 P.M.—Society Meeting—Subject: To be announced later. Location: Waldorf-Astoria Hotel, Lexington Avenue at 49th Street, New York City.

Message from President Fedde

For some of the younger members of our profession who are being called into military service, there exists a serious problem with respect to the continuation of their practice. In many cases much time and effort have been expended by these men in building up a sound and profitable clientele. But unless proper attention can be given to the affairs of these clients, the young accountant now entering upon his year of military training will return to find his business neglected, with the possibility that his practice—during his absence—will have vanished. I need not point out further the seriousness of such a situation, nor the fact that all members of the profession should feel a responsibility for seeing that such a condition does not come about.

It seems to me to be incumbent upon the older members of the accounting profession, particularly those past the age of military service, to come to the rescue of their younger contemporaries in this emergency. In my opinion, the young accountant with an active practice, who finds himself called up for service, should feel free to request an older member to take over his work in his absence. He should be made to feel that during his year of military training his affairs will be properly taken care of for his account, he will receive what is owing to him, and that upon his return his practice will be turned back to him again.

This is a real service that older members of this Society can render to those men who some day in their turn will be taking over the greater responsibilities of the profession. Therefore, I sincerely hope that any requests for assistance on the part of our younger practitioners will be cheerfully and willingly met by their elders, and that the latter will put forth every effort during the term of enforced absence to assure the proper administration and return of such affairs as may be entrusted to their care.

Radio Programs

The Society has secured radio time over Station WOR for the presentation of two programs which will be of assistance to the general public in making out their 1940 income tax returns. The material used in formulating these programs has been prepared with the assistance of the Committee on Federal Taxation, of which Mr. Nicholas Salvatore is Chairman. It was felt that there was a particular need this year for a public service of this kind on the part of the Society in view of the changes in

the income tax laws. These broadcasts are to be in question and answer form, and the information to be given is aimed principally at taxpayers in the low income groups, the numbers of which will be greatly increased this year due to the lowering of the gross income factor and the rates for personal exemptions. The President of the Society, Mr. A. S. Fedde, will be the principal in these broadcasts, and he will be interviewed by an average taxpayer seeking information on how to file his return.

It is hoped that members of the Society will listen to these broadcasts. The Public Relations Department will appreciate receiving any comments or suggestions on the part of the members with respect to this initial effort, which it hopes to continue every year. Similar broadcasts are also being planned over local stations in our chapter cities, Albany, Buffalo, Rochester, and Syracuse.

The times and dates of the two broadcasts over Station WOR in New York City are as follows:

Tuesday, March 4th—5 to 5:15 P. M.

Tuesday, March 11th—5 to 5:15 P. M.

Inasmuch as these periods are subject to last minute change by Station WOR, members should consult the newspapers beforehand to make sure that no postponement has been made.

Geographical Directory of Members

To meet the requests of bankers, credit men, trade associations and others interested, 8,000 copies of the Directory of Members of The New York State Society have been distributed this month. The number of communications and telephone requests received for copies of this publication indicate that it is constantly being used by these groups.

This Directory is not sent to the members of the Society. However, any member wishing a copy of the Directory may obtain one upon request.

We wish to call the attention of the members to the fact that the 1941 Directory has been arranged *geographically* instead of *alphabetically* as was the practice in previous years. This new arrangement was decided upon after much consideration, as it was thought that a geographical list of our members would be more helpful to the banks, credit men, and others who use this Directory in locating certified public accountants in other cities and states.

March Society Meeting

Appraisals as Related to Accounting will be the subject of the March 17th meeting of the Society to be held at the Waldorf-Astoria Hotel at 7:45 P. M. Mr. Lyle H. Olson, of the American Appraisal Company, will be the principal speaker. Mr. Henry A. Horne will comment on Mr. Olson's address, and a question and answer period will follow.

Members attention is called to the fact that as provided in the by-laws seven members of the Committee on Nominations will be chosen at this meeting for the nomination of officers and directors.

Edward T. Perine

Edward T. Perine, of the firm of Perine & Co., died on January 16, 1941, at the age of 70. Mr. Perine was a member of the Society since June, 1938.

He was the author of two books and also contributed financial articles to various publications and was a frequent speaker at bankers' conventions and similar meetings.

He is survived by a daughter.

The Society, as well as the accountancy profession, have suffered a real loss in his passing.

PROFESSIONAL COMMENT

Dun & Bradstreet Natural Business Year Studies

Commencing in March, 1938, the Research and Statistical Division of Dun & Bradstreet, Inc., in cooperation with the Natural Business Year Council, has published at frequent intervals a series of Bulletins analyzing the seasonal characteristics of various industries with respect to production, sales, inventories, receivables and liabilities. These Bulletins take up the question of fiscal closing dates, and recommend the more natural and appropriate fiscal dates for the various types of industries studied.

The latest Bulletin—No. 25—deals with the Fertilizer Manufacturing industry. Below are listed the other Bulletins already published, which are available upon request at the office of the Natural Business Year Council, 13 East 41st Street, New York City.

No. 1. Fur Coat Manufacturers
No. 2. Radio Manufacturers
No. 3. Women's Trimmed Hat Manufacturers
No. 4. Farm Equipment Manufacturers
No. 5. Department Stores
No. 6. Shoe Manufacturers
No. 7. Flour Millers
No. 8. Dry Goods Wholesalers
No. 9. Producers of Crude Cottonseed Oil and Refiners of Cottonseed Oil
No. 10. Jewelry Retailers
No. 11. Furniture Manufacturers
No. 12. Paint, Varnish & Lacquer Manufacturers
No. 13. Cement Manufacturers
No. 14. Fruit & Vegetable Canners
No. 15. Candy Manufacturers
No. 16. Hosiery Manufacturers
No. 17. Men's Work Clothing Manufacturers
No. 18. Women's Coat and Suit Manufacturers
No. 19. Cotton Textile Weavers
No. 20. Retail Drug Stores
No. 21. Lumber and Building Material Retailers
No. 22. Meat Packers
No. 23. Breweries
No. 24. Oleomargerine Manufacturers

Securities and Exchange Commission

On page 329 of this issue is published Accounting Series Release No. 21, containing certain amendments to rules 2-02 and 3-07 of Regulation S-X. With particular reference to the question of accounting certificates, the Committee on Auditing Procedure of the American Institute of Accountants is now preparing a statement on any revisions that may be necessary to the standard short form of auditor's report. This statement will appear in the March issue of the JOURNAL OF ACCOUNTANCY.

Selection of Accountants by Directors

On January 2nd the Securities and Exchange Commission announced in release No. 41, Investment-Company Act of 1940, the adoption of rule N-6C-7 temporarily exempting certain registered investment companies from the requirements that their independent public accountants be selected by those directors of the company who are not directly concerned in its management.

Section 32 (a) of the investment-company act sets up certain procedures to be followed in the selection of independent public accountants for investment companies, among which is the requirement that they be selected by a majority of those members of the company's board of directors who are independent of the management—that is, who are neither officers, employees, nor investment advisers of the company, nor affiliated persons of such an investment adviser—and that the selection be submitted for "ratification or rejection" at the next succeeding annual meeting of stockholders. At the present time certain companies do not have the independent directors needed to meet this requirement. After November 1, 1941, when the provisions of section 10 (a) of the act become effective, at least 40 per cent of the board of every registered investment company will have to consist of persons independent of the management, but the legislative history of the act clearly indicates that until that date there should be no legal compulsion to change the composition of existing directorates.

The effect of rule N-6C-7 is to permit the selection of independent public accountants until November 1, 1941, by a majority of the whole board of directors of those companies which are not presently able to comply strictly with the requirements of section 32 (a) of the act.

American Institute Publication

The American Institute of Accountants has recently published in book form more than 40 papers presented at the Institute's annual meeting held last October in Memphis, Tenn. This book, entitled EXPERIENCES WITH EXTENSIONS OF AUDITING PROCEDURE, also contains papers dealing with the internal conduct of an accounting practice, audits of building and loan associations, accounting for the oil industry, audit working papers, accounting procedure and research, professional ethics, and many other topics. It includes addresses by Jerome N. Frank, Chairman of the Securities and Exchange Commission, Leland Olds, Chairman of the Federal Power Commission, and Ewin L. Davis, Chairman of the Federal Trade Commission.

Copies of this book are available at the office of the American Institute of Accountants, 13 East 41st Street, New York City, price $1.00.

Balance Sheet of the Future

There has recently been published by Dun & Bradstreet, Inc., a pamphlet entitled THE BALANCE SHEET OF THE FUTURE, prepared by Roy A. Foulke, Manager of the Specialized Report Department of that organization. This pamphlet bases its comments on the replies received to a questionnaire sent to a selected group of business men and public accountants in which sixteen questions were asked which sought to determine the probable character of financial statements of future years. These questions dealt with the desirability for expanding the inclusiveness of the present-day balance sheet, and for the need of effecting changes in current methods of reporting and accounting for inventories, investments, deferred liabilities and surplus.

The replies to this questionnaire have been deemed of sufficient importance to merit the attention of the Society, and therefore the pamphlet is being referred to the Committee on Practice Procedure for their critical review and opinion. The comments of this Committee will be published, when received, in these columns.

ELECTIONS

THE following is a list of applicants admitted to membership and associate membership in the Society, and also associate members advanced to membership at a meeting of the Board of Directors held on January 8, 1941:

Membership

Bernstein, A. David, 475 Fifth Avenue,
Of Bernstein & Milchman.
Bonchek, Henry, 570 Seventh Avenue.
Cadley, M. J., 47-51—33rd Street, L. I. C.,
With Pepsi-Cola Company.
Cohn, Maurice, 80 Maiden Lane,
With Touche, Niven & Co.
Danch, John L., 80 Maiden Lane,
With Touche, Niven & Co.
Geisel, George, 350 Madison Avenue,
With Hurdman and Cranstoun.
Golden, Nathaniel J., 11 West 42nd Street,
Of Shacter & Golden.
Goldman, Samuel, 45 John Street,
Of Baumgarten & Arum.
Hastings, James J., 24 Commerce Street, Newark, N. J.,
Of James J. Hastings & Co.
Jablow, Alexander, 551 Fifth Avenue,
Of Jablow & Jablow.
McLaughlin, Leighton Bates, 42 Broadway,
Of White, Bower & Prevo.
Neill, John William Fraser, 56 Pine Street,
With Price, Waterhouse & Co.
Odell, Joseph Davis, 370 Lexington Avenue,
With Paper Shipping Sack Manufacturers Association.
Rockey, Charles Snowden, 1200 Bankers Securities Bldg., Walnut and Juniper Streets, Philadelphia, Pa.,
Of Charles S. Rockey & Co.
Santivasi, John Virgil, 85-52—148th Street, Jamaica, L. I.
Vogel, Nathan, 11 West 42nd Street.
Wagner, George, 67 Wall Street,
Of Arthur Andersen & Co.
Weiler, William Scott, 70 Pine Street,
With Peat, Marwick, Mitchell & Co.
Wiener, Irving I., 2 Park Avenue.

Associate Membership

Williamson, Robert John, 1013 Liberty Bank Bldg., Buffalo,
With Lucker & Severance.

Advancement from Associate Membership to Membership

Bini, Benedict, 152 West 42nd Street,
Ass't. Controller, Terminal Barber Shops, Inc.
Deutsch, Eugene A., 1441 Broadway,
Of Hyans, Stern & Company.
Evans, Peter Guy, 60 Wall Street,
With Morris & McVeigh.
Freeman, Marcel Maurice, 60 East 196th Street.
Gallagher, Philip C., 67 Wall Street,
With Arthur Andersen & Co.
Greulich, Charles, 212 Fifth Avenue,
With Sam Finkelstein & Co., Inc. of Va.
Hailer, George W., 120 Broadway.
Hirschlag, Harold W., 19 West 44th Street,
With Margold, Ersken & Wang.
Jacobs, Earle E., Jr., 19 West 44th Street,
With Klein, Hinds & Finke.
Koby, Morris, 12 East 41st Street,
Of Koby & Spector.
Leatherbee, Clinton F., 430 E. 86th Street.
Luper, Oral Leon, 1720 Rand Bldg., Buffalo,
With Price, Waterhouse & Co.
Mishkin, Edward A., 155 John Street,
With Rothschild-Samuels-Duignan, Inc.
Muldowney, James Xavier, 30 Broad Street,
With R. G. Rankin & Co.
Nerenberg, Sidney, 152 West 42nd Street,
With Sudman Audit Company.
Neumann, William, 40 Rector Street,
With West, Flint & Co.
Olsen, George, 107 William Street,
With Fedde & Company.
Rashkin, Benjamin, 521 Fifth Avenue,
With Eisner & Lubin.
Reck, Paul Ashley, Manhattan Bridge Plaza, Brooklyn,
With Sperry-Gyroscope Company, Inc.
Reid, David F., 60 Hudson Street,
With Lamont, Corliss & Co.
Stack, Francis, 609 West 187th Street.
Tonjes, George M., 30 Rockefeller Plaza,
With First Federal Savings and Loan Association of New York.
Winderman, Milton, 111 Broadway,
With Schapiro & Schapiro.

The number of members in the Society as of February 1, 1941 is as follows:

Members	3,402
Associate Members	448
Total	3,850

State and City Taxes

By Isidor Sack, C.P.A.

WHERE a family with several children is blessed with a new arrival, all interest and attention is centered on the stranger and the older children suffer neglect, particularly if the newcomer should display any queer characteristic or give signs of peculiar development. So it has been with our tax family. We have had several additions to it during 1940 and we have been so preoccupied with understanding if not admiring the latest arrival that we have neglected the older taxes which we have had with us for many years and have lost sight of the fact that they present problems of their own and that they still deserve attention.

It sometimes seems as if only through reduction of taxes can any of the fruits of enterprise be retained for the owners, and we do have the job of preparing State and City tax returns, so our job this evening will be the consideration of a miscellaneous assortment of State and City taxes.

I will consider some features of the New York State Corporation Franchise tax, Personal Income Tax, New York City Sales Tax, Use Tax, Gross Receipts Tax.

I will be able to deal only with some phases of them and not completely with any of them; the result may be a rather kaleidoscopic review, but that is the nature of my assignment.

Corporation Franchise Tax

Most of the new problems arising under this law are not the result of rulings but arise out of discussions among accountants arguing for clients and in the absence of rulings the answers are not known. But the presentation of the argument on behalf of the taxpayer may be of some use to you. I will discuss a few of these for what they are worth.

The Income Base:

The state taxes "the entire net income"—a term which curiously enough has not been defined. The law states that the entire net income is presumably the same as the entire net income which the corporation is required to report to the United States, after certain designated changes therefrom.

The decisions and the practice of the department, while not consistent, gives support to the view which I hold that *true net income* is the basis. Without any statutory definition of this term you may, in some border line case, have to leave it to the court to decide what income is as a matter of law. But if you have an item which clearly enters into the determination of income, but which is not allowed or recognized in the federal definition of income, it should enter into the determination of true net income.

The federal law contains nearly a dozen definitions of income of one kind or another for special sections of the law and for special classes of corporations and we have seen the federal definition of income change annually.

When you are faced with an out-of-the-ordinary transaction you should determine what its true effect is on net income and not be controlled by the federal treatment. So, for example, if a loss on the sale or exchange of a capital asset is in fact sustained, but is not recognized fed-

Presented at the January 14, 1941 Meeting of The New York Chapter of the National Association of Cost Accountants.

erally because it arises out of a transaction regarded as tax-free under the federal law, it is my opinion that the loss nevertheless should be deducted in the determination of true net income.

Deductions for expenses or losses actually sustained, even if not allowable for federal purposes, or allowable only in part, are nevertheless deductions which must be made to ascertain true income.

The federal law did not allow capital losses as deductions, except to the extent of capital gains and even now has a similar provision with respect to short term capital losses. Without any specific provision in the state law, the department allowed all excess capital losses on the state returns.

This confirms me in the view that the state's basis is independent of the federal definition of net income. The state law has recently been amended specifically to provide for this deduction of excess capital losses.

It is surprising to me that this subject is not dealt in by any reported tax case. I suspect there has been some compromising and settlement work going on within the department whenever this point was raised.

Segregation:

If the entire business of a corporation is transacted within the State the tax, if measured by income, is imposed on all of its income. If however, the entire business is not transacted within the State then the tax is on a proportion of such income determined by some headache-producing allocation formula. At another point the law states that if a corporation maintains no regular place of business outside of this State, except a statutory office, it shall be taxed on its entire net income. To this there is one exception introduced in 1940. A corporation which owns real estate outside of the State is permitted to segregate all of its assets regardless of whether it maintains a place of business outside of the State.

Now then, is a corporation that actually does business out of the State taxable on all its income or is it entitled to the benefit arising from segregation of assets. The answer cannot be given with assurance but I will present the case for the right to segregate. The doubt is created by the use of various terms in several sections of the law bearing on this subject.

One section refers to "transacting business", another to "maintaining a regular place of business", and the exception for the companies owning real estate states that such a company "shall be deemed to be doing business" outside of the State. Whether the test of the right to segregation is "transacting business" or "doing business" or "maintaining a regular place of business" is not at all clear.

It is well recognized that a corporation may transact business within a State without maintaining a regular place of business therein. For example: it may have sales agents, goods and warehouses, may make deliveries from such goods and do many things without maintaining a place of business. A building contractor may have a job in another state. It is conceded that a foreign corporation without any place of business in this State, but which nevertheless transacts business in this State is reached by the same franchise tax law. Whether a corporation will lose its right to segregate assets outside of the State, even though it transacts business outside of New York, just because it maintains no regular place of business elsewhere, is one of the important questions about this law that is still in doubt.

If your company has assets outside of the State and transacts busi-

ness outside of New York, you should claim the benefit of segregation even though you maintain no place of business except in New York.

But here is a more curious point: Once you establish the right to segregation because you maintain a place of business outside of the State you may then segregate all assets without the State, even those located in states other than the one in which you maintain a place of business. To illustrate: Suppose a corporation, whose principal place of business is in this State, maintains a branch in New Jersey, but does business through sales agents in Illinois, keeps goods in warehouses on the west coast and owns merchandise being processed for it in other states. You now have the right to segregate all assets outside of the State according to the statutory formula, and are not restricted to the assets which are located in New Jersey where the company has a branch.

But until this question is definitely adjudicated, it may become profitable to establish at least one place of business out of New York so as to be sure of the right to segregation.

In the textile business, for example, corporations may have merchandise in the hands of printers and dyers in New England and the southern states, and merchandise may be shipped from such points directly to a customer. If a place of business, however small, is established in some state outside of New York, all assets located at these points and accounts receivable arising out of deliveries from such points may become out of state assets and substantially reduce the tax. From the fact that the law takes this pattern, I believe that it is the legislative intention to permit segregation if business is being done outside of New York, regardless of whether a regular place of business is maintained.

Consolidated Returns:

Can a corporation be forced to pay a tax on a consolidated basis unless there is an improper arrangement between the affiliated companies? By an improper arrangement I refer to charging a sales subsidiary so high a price for the merchandise that it cannot make a fair profit, or charging it an excessive amount for services or for money advanced, etc. On the subject of consolidated returns, you must follow closely so as to understand what the law says and what the law does not say.

One section of the law provides that a parent company may be required to file a report consolidating its operations with those of its subsidiary and that a subsidiary company subject to a New York tax may be required to file a report consolidated with the owning company.

Now these are merely provisions for filing returns and no taxing powers are contained therein. The same section states that if it shall appear to the Tax Commission that there is an improper arrangement which results in an improper reflection of the business done on the net income earned from the business within the State, or the segregable assets, the Commission is empowered to equitably adjust the tax.

These three provisions are all in one section and it seems reasonable to argue that the first two provisions are merely designed to give the Commission the information from which it can determine whether an improper arrangement exists and, if it so finds, to impose a tax on the equitable basis authorized by third provision. In the absence of an improper arrangement the power of the Commission to impose a tax on a consolidated basis, if it exists at all, must be construed only from another section of the law, which provides that where a consolidated return is filed the Commission may

assess the tax against either of the corporations.

Now in form this does not add to the Commission's power to tax or to the amount of the tax imposed, but may be considered to mean merely that where a consolidated report is filed, the Commission does not need to look too closely to determine precisely which of the companies involved should be taxed, particularly where it uses its power to adjust the tax equitably on account of an improper arrangement, but may assess the tax against any of the corporations involved. On the other hand it may be argued that the tax should in all cases be determined on a consolidated basis where consolidated returns are called for. What the courts will decide is of course not predictable.

I do know that some of the staff of the Tax Department entertain some doubts about the Commission's rights to determine the tax on a consolidated basis unless an improper arrangement exists, and you should bear this in mind if the problem presents itself.

Excess Amortization of Defense Plants:

The Second Revenue Act of 1940 has special provisions with which you are familiar by now I trust, permitting in certain cases amortization over a 60 month period of the full cost of emergency facilities. There is no similar provision in the State franchise law. However, the Commission has announced that it will reach a similar result through allowances for depreciation and obsolescence.

The decision of the tax commission was recently announced by the Governor who stated that no amendment to the law is required to coordinate the State and Federal defense programs in the matter of taxes on corporations.

Interest Paid to Members of a Family:

Under Article 9-A the interest deduction is limited so as to exclude interest to stockholders and members of their families. The term has been defined by a ruling published this year to be the same as the Federal definition of members of a family, namely, to include brothers, sisters, spouse, ancestors and lineal descendants of such stockholders.

Capital Stock Basis:

A business corporation is required to compute the tax on the income basis and the capital stock basis, and pays whichever tax is higher.

The state law is sprinkled with such pleasant opportunities. Before an amendment adopted in 1940 the date of valuation of capital stock was not stated. The form of return called for information as to the average value during the year, the value at the end of the year, and at the beginning of the franchise year, and occasionally each of these was used. Now the law has been clarified and value at the close of the taxable year is the basis.

Dissolution:

The dissolution of a corporation prior to the close of the franchise year was required in order to avoid a tax for the following year. Now a 20 day period of grace has been granted, and a business corporation may conclude a dissolution by November 20th or a real estate corporation by January 20th, providing proceedings were begun before the beginning of these months.

Field Auditors:

The field examination of a corporation return was a rarity. In fact it is more likely than not that if you had such an examination it was because some auditor of the Tax Commission had something on you.

The legislature has been persuaded that field examinations would

be productive of profit, so an appropriation was made for the special purpose of conducting more field examinations of tax returns and a competent accountant has been placed in charge of the work, and you may now look forward to having State audits, if not as uniformly as federal audits, at least occasionally.

Personal Income Tax

Capital Gains:

The State Capital Gains Tax is entirely separate from the income tax. The only connection between them is with respect to the personal exemption. If you do not have enough income to absorb your personal exemption you may carry over the unused portion against the capital gains tax. None of the distinctions between long term and short term gains or losses appear in the State law. It is important to consider these differences where sales are made solely for the purpose of reducing U. S. taxes. There may be an offsetting disadvantage on the State tax.

There is a difference between the State tax on net capital gains and the Federal tax that deserves attention. Under the Federal law a loss from the sale of a capital asset is deductible only if the asset was acquired in a transaction entered into for profit. Under the State definition all assets other than those you include in inventory are capital assets.

One result is that the loss on the sale of a residence, while not deductible federally, is deductible from capital gains on the state return. Another difference is that the state definition of "capital asset" does not include either land or equipment used in a trade or business, whereas the federal law includes land as a capital asset, making it necessary on the sale of a plant to apportion as between land and building both the cost and the selling price.

Correction of Taxes for Outlawed Years:

The State made a start toward meeting the situation covered by Section 3801 of the Internal Revenue Code. Section 373 has been amended to provide that if the Commission disallows a deduction in the current year on the ground that it should have been taken during any of the five preceding years, a refund may be allowed in the prior year even though otherwise outlawed. But the refund will be limited to the amount of the additional tax assessment of the current year. This is of limited application obviously.

If the taxpayer is in the same tax bracket in the current year as in the earlier year, the refund will offset the assessment and probably no adjustment will be made. It does however permit the Commission to allow a deduction which might otherwise be outlawed.

For example, an embezzlement is ordinarily a loss in the year in which it occurs, but suppose (through failure of the embezzler to file an information return) it is not discovered for three years after the event? You can't deduct it during the year of discovery and but for this section you would be without relief.

Of course neither this provision nor the companion provision of the Internal Revenue Code reach all cases of double taxation, but they are both salutary steps in the right direction and for this we should be thankful.

Bad Debts on a Reserve Basis:

Beginning with 1939 a taxpayer (individual, partnership or fiduciary) filing a state return has the option to treat all bad debts either on the basis of taking deductions for debts ascertained to be worthless or by a reserve for bad debts. Prior thereto the reserve method was not permitted. The option was available in 1939 and if not taken then no

change can be made except upon the approval of the Commission. Presumably the Commission will permit a taxpayer to adopt for State tax purpose the same basis as he uses for Federal taxes.

Deduction for Unincorporated Business Tax:

The Appellate Division decided that the unincorporated business tax is an income tax and may not be deducted from personal income. This confirms the prior ruling of the State Tax Commissioner. (Froelick v. Graves).

Dividends Paid by Companies with a Deficit:

The Federal law was amended in 1936 to include as a dividend a distribution by a company having an impaired capital, provided the dividends were paid out of the earnings of the current year.

The State has no such rule but subtantially the same result has been reached through a decision of the Court of Appeals, which held that distributions out of current earnings were dividends under the State income tax law, even though the company had an earnings deficit at the beginning of the year in excess of the earnings of the current year.

Wash Sales—Stock Dividends—Sales to Members of a Family:

There are two long standing differences between the Federal and Personal Income Tax Laws, which, notwithstanding that they have existed for many years, have not been wholly understood and for that reason I mention them here.

The Federal law now taxes stock dividends with the exception that common stock dividends paid to common stockholders are still free from tax.

The State law still says that stock dividends are not taxable, and I believe that common on preferred and preferred on common still are free from tax under the State law.

This means not only that the income of the year in which dividends received will be different under the two laws, but also that the basis on sale will be different.

Another point is that losses resulting from wash sales of securities (that is, where securities similar to those sold were bought within 30 days before, or within 30 days after the sale) are not deductible. There has never been such a provision in the State law and losses from such sales are deductible. This means that there will similarly be a difference in the year when such sales are made and also in the basis of the stock purchased.

Since 1936 losses on the sales of securities to members of a family and certain affiliated persons have not been allowed as deductions for federal tax purposes. There is no similar State provision.

Deductions for Charitable Contributions:

Under the federal and state laws deductions for charitable deductions may be taken to the extent of 15% of the taxpayer's net income. By reason of several federal decisions capital gains are included in the base for the computation of the 15% limitation, while net capital losses do not reduce this base federally. Under the state law, however, as capital gains and losses are separated from the report of ordinary net income, net capital gains or losses do not enter into the computation of the base. The result is that the deduction for contributions is limited to 15% of the ordinary net income without regard to net capital gains or net capital losses.

City Retail Sales Tax

The ostensible object of this law is to tax receipts from retail sales of tangible personal property not

purchased for resale. The law is designated as a retail sales tax, but you will find that it taxes you even if you buy it wholesale and even if you buy what the law has been accustomed to regard as real property. This is done by a series of definitions. The law starts out to impose a tax on the "receipts from every sale of tangible personal property sold at retail". Every word in this term is pregnant with meaning and has been defined to have a meaning other than that which it has in every other field of law.

A retail sale is defined as "a sale to any person for any purpose other than for resale in the form of tangible personal property". Here the word "retail" has been decently buried and is never heard of again.

Receipts from the sales of tangible personal property somehow includes receipts from the rents of personal property, as the term "sale" is defined to include license to use.

By these definitions the law has been broadened so as to apply to all purchases made by the ultimate consumer of the thing purchased.

When the question of imposing a sales tax is discussed, the argument in favor of a tax on retail sales as against the tax on manufacturers' sales, is that there will be no pyramiding of the tax in the former case. Nevertheless by definitions and through administration, there is a substantial amount of pyramiding of the tax involved in all cases where a manufacturer is held to be the ultimate consumer of certain things that he buys, and he must pay the tax thereon and presumably add it on to the sales price, on which the retail sales tax is ultimately collected.

Sales to Manufacturers:

There is great difficulty in defining with any accuracy or satisfaction which purchases made by a manufacturer are taxable to him as the ultimate consumer, and which he buys for resale. The regulations are confusing. There is no consistency between them and few of the decisions should be accepted without question.

I have had no personal experience with this law but from discussions with others, and a review of the regulations, I do not get the idea that the Department is trying to reach a correct answer, but rather that it is afraid of being wrong and therefore leans toward imposing the tax in all doubtful cases, leaving it to the taxpayer to correct them by court action. This is an understandable point of view, but an unfortunate one.

An interesting series of rulings has to do with materials which become part of the finished product which is sold. The regulations exempt from tax, sales of tangible personal property for use as a component part in the construction, manufacture and fabrication of other personal property. Broadly stated, the rule is that a manufacturer is himself the ultimate consumer of those articles and supplies which we as cost accountants would include in overhead and general burden and therefore all sales to him of such supplies are subject to a sales tax, and on the other hand those materials and supplies which enter into the production of the thing he sells, and which cost accountants include as part of the direct cost, are exempt from sales tax, as the sales tax is imposed on the finished product.

The regulations give a few simple illustrations of transactions that are free from doubt. As for example, they state that when cloth, linings, buttons and thread are sold to a manufacturer of clothing, these are component parts of the clothing he manufactures, and are not taxable upon sale to the manufacturer, as the suit or dress is taxed when sold at retail. If, however, you go to Bermuda and buy several yards of doe-skin cloth and take it to a tailor

to make up a suit, his charge for the labor is not taxable but he becomes the ultimate consumer of the buttons, lining, thread, etc. which he uses and he must pay the tax on the purchase thereof.

So also we can easily understand that if an automobile manufacturer buys tires, bumpers or accessories—these become component elements of the thing he sells and he buys them for resale and is not taxed thereon.

The regulations also state that paints, sold to manufacturers of furniture, becomes a component part of the furniture sold and therefore sales of paint to a furniture manufacturer are not taxable. On the other hand, the gold filling in your teeth is not the component part of anything sold to you, so the purchase of gold by the dentist is taxable to him as the ultimate consumer. He merely renders a service which is not taxed.

Among the "yes and no" answers given by the regulations is one dealing with the sale of chemicals to photo engravers. Just so as to create an arbitrary rule of thumb which would be administerable, the comptroller ruled that 20% of the chemicals sold to photo engravers constitute component parts of the engravings sold and the balance constitute materials bought by him for his own use.

We come to situations that cannot be resolved so easily.

In the Mendoza Fur Dyeing case the court held that sales of chemicals to a fur dyer who employs them in the process of dying materials owned by others is not for resale and is subject to the retail sales tax, the court taking the position that the fur dyeing company sold a service of dyeing and was itself the consumer of the dye.

The ruling would probably be different if dyes were bought by the manufacturer of the furs. It would probably be held that the dyes became a component part of the fur.

Among the purchases by manufacturers which are taxed to them as materials consumed are the following:

Sales of materials to a barber shop.
Designs to be impressed on cloth sold to manufacturers of dress goods — (Foremost Studio v. Graves, 246 A.D. 130).
Machinery, tools and equipment.
Coal and fuel used in production.

The purchases by a chemical manufacturer will give rise to many hair splitting distinctions. When does a chemical bought by a manufacturer become the "component part" of the product he sells. If a chemist uses two basic chemicals, and then introduces a solvent, which changes the two base chemicals and creates a different one and dissolves in the process, is that solvent a component part of the ultimate product manufactured for resale? I think it is—what the comptroller thinks is not known.

Containers:

With respect to containers there is a good deal of high class thinking to be done to decide when the container is consumed by the manufacturer and when it is purchased for resale.

All cans for canned goods, paints, etc., bottles, boxes—all items which actually accompany the product sold to the final buyer or ultimate consumer are not subject to tax, but crates, packing cases, etc, which do not pass to the ultimate consumer with the personal property containing them are taxed to the manufacturer as the ultimate consumer. From that simple rule you go to the many industrial uses of barrels, boxes, drums, cartons, etc. and the nearest rule you can follow is this: If the title to the container is retained by the seller and the container is to be returned to him, then the manufac-

turer is a consumer and required to pay the tax, whereas if the buyer of a product also pays for a container and keeps it, he is the buyer and the sales price is supposed to include the charge for the container.

In the cases of American Molasses Co. and Sterling Bag Co., the court held that barrels, drums and sugar bags which are sold to customers specifically, or where the price of the product varies with the type of container, are containers which are sold and therefore included in the sales price and not taxed to the manufacturer.

In these cases, the title to the containers passed to the purchasers in bulk. The containers did not always reach the ultimate consumer but were retained by the purchaser in bulk and usually resold as junk.

Services:

Receipts from services are not taxed. In Dun & Bradstreet v. N. Y., 168 Misc. 215, it was held that the book of credit ratings remains the property of Dun & Bradstreet and is not sold so the charge made by the company is made for services and no part of it includes the sale of tangible personal property.

Fur dyers, dry cleaners, laundries, etc. are service industries. They pay the tax on materials consumed by them and do not tax the purchasers of their services.

Finance, interest, or carrying charges, service or installation charges, if shown separately are not included in the amount of receipts from sale. They must be shown separately to reduce the tax. So also with delivery charges if added to the sales price and shown separately on the invoice, no tax is payable thereon.

The tax is on the consumer. It does not tax the sale of service but only of tangible personal property and does not tax sale of real estate or improvements erected on land. These considerations have led to what seem to be peculiar rulings with respect to building construction and repair, weaving a line dangerously close to a forbidden tax.

It is held that a general contractor agreeing to put up a building is not selling tangible personal property but is selling a service, and he therefore is the consumer of the building supplies, bricks, plaster, plumbing, electric fixtures, etc., which he must use in performance of his service to deliver a completed building.

Illustration: (1) A window was broken. I go to a glazier and say, "I want the window repaired". He says "I will do the whole thing, window and all, for $10." That is a contract for service and the contractor is the consumer of the glass.

(2) I go to another glazier and he says, "I will sell you the glass for $6. and charge you $4. for installation." This is a dual contract, and the contractor should charge a sales tax on the $6. The owner of the building is the consumer of that.

(3) Another glazier says, "I will sell you a pane of glass for $10. and install it free". That is a contract for the sale of goods and the services are simply incidental, so that the $10. is subject to the sales tax.

A builder of a yacht sells the yacht, so any materials he buys for inclusion in the yacht are bought for resale, and he is not a consumer thereof, and therefore pays no tax, but he collects the tax from the buyer.

The builder of a house on the other hand, sells what the department calls a service, and so is a consumer of materials and pays the tax thereon, and does not charge a sales tax to the buyer.

The City in its explanation of this rule seems to classify the erection of a building by a contractor as the performance of a service. Not that it makes any difference upon what ground you are taxed, so long as the

tax sticks, but I think that the real basis for this rule, if it is valid at all, is to be found in the definition of a sale at retail, which is subject to taxation, as a sale for any purpose other than for resale in the form of tangible personal property. A builder does not buy materials for resale in the form of tangible personal property so the sale to him is within the definition of a sale at retail, and therefore taxable.

Sales in Interstate Commerce:

The interstate commerce clause of the federal constitution used to be a protection against taxes imposed by states and cities which had the effect of restraining or interfering with interstate commerce. What Judge Frankfurter frankly stated was a reconstructed Supreme Court has destroyed many of our old concepts and has now permitted the City of New York to impose a tax on sales in interstate commerce which previously were forbidden.

In an historic case, the Berwind-White Coal Co. case, the Supreme Court held that the New York City sales tax could be imposed upon sales of coal from a mine in Pennsylvania to a dock in Jersey City and delivered thence by barge to New York City. This notwithstanding that the enabling act itself stated that the tax would not apply to any transaction originating and/or consummated outside of the territorial limits of the City. In this case the vendor maintained an office in New York City.

The sales contracts were entered into in New York and called for delivery in New York City. The court held that the tax was on the purchaser and was sustained because it did not involve any discrimination against interstate commerce. Since then, and on authority of this decision of the Supreme Court, the Appellate Division held that the retail sales tax is applicable where the order was taken by a salesman operating from the New York office of the vendor but sent to the out of state office for acceptance and shipment was made f.o.b. out of the state. Here the transaction was completely consummated out of the state, from the acceptance of the order to the delivery of the merchandise.

The City sales tax was upheld as being laid on the sale or purchase of goods upon the arrival at their destination at the end of an interstate journey.

The Berwind-White Coal Mining case must now be accepted as authority for the proposition that nondiscriminatory taxation of the instrumentalities of interstate commerce is not prohibited by the constitution.

This changed point of view on the nature of the restraint on interstate commerce imposed by local laws may lead to new concepts of a state's power to tax and none of it bodes any good for the taxpayer.

The Berwind-White case covers these situations:

Order received here and accepted here.

Order received here and forwarded to the home office for acceptance and shipped from without the State direct to the customer.

The only question open after the Berwind-White case is this: If the vendor does not maintain a place of business in New York and the order is sent from a New York customer to the home office, can the City compel the vendor to collect the tax. If the answer is, No, then the use tax applies.

The corporation counsel has ruled since the Berwind-White decision that shipment of merchandise by out-of-state merchants to foreign buyers for export, the title passing in New York City, is not by reason of that fact subject to the New York sales tax.

Trade-Ins

Trade-ins do not constitute part of the gross receipts from sales and are not taxed to the buyer. The rule is different with respect to the use tax. A concern without an office in the city cannot collect the sales tax. It is therefore possible for its customers to be subject to the use tax, which may be higher than the sales tax when a trade-in is involved.

For example: If a resident of New York buys an automobile for $1500., and receives a $500. allowance on the old car turned in, he is subject to a sales tax of $20. on $1000. However, if in order to avoid the sales tax he buys the car out of the City he will be subject to a use tax of 2% on the total cost of the car, or $30.

Reorganizations:

The regulations state that if a reorganization has the effect of a sale or exchange of tangible personal property, the receipts in the form of cash, securities or other property are taxable to the extent that they are for goods acquired for consumption and not for resale. This regulation should not be accepted without question.

It would be a fair regulation if the vendor were entitled to a refund of the tax paid on the acquisition of property for consumption, and which it now sells subject to the tax. If this credit or refund were allowed, the two would offset each other and there would be no additional tax due.

There is a regulation which states that where property is purchased for consumption and is later resold, the vendor may within one year of the date of payment take as a credit against the tax to be paid, the amount which he paid. It is doubtful whether this regulation will apply in the case of a reorganization, but if it does not, the regulation just referred to is inequitable, as it had the effect of piling one tax on another, where the law intends there should be but a single tax.

Application for Refund:

The law provides for refund only for taxes paid under protest in writing, stating grounds of protest and if application for refund is made within the year of the payment of the tax.

The vendor may make a claim for refund only if he has paid the tax, and not collected it from the purchaser, or having collected it has refunded it. The purchaser can apply for a refund if he has paid it. The purchaser can take the credit against his own tax if he is subject to any.

Preparation of Returns:

The City Sales Tax Bureau is an overworked organization and selects for field audits those returns which are incomplete or indicate probable inaccuracy. You can avoid a field audit if all the schedules on the inside of the form are sufficiently completed and filled in, and deductions are pro-rated quarterly so as to give evidence of consistent treatment of all items and probably accuracy. In the audit of retail sales tax returns the auditors do not usually examine the entire period, but make test audits. The period selected for an audit may not be indicative of the treatment throughout the year, and if you prepare a protest carefully you can generally disprove the accuracy of tests which were in fact made over a period that is not comparable with the results for the entire year.

Statute of Limitations:

The State enabling act provides for a limit of three years from the date of filing a return for making assessments. The regulations are silent on the provision contained in the State law to the effect that taxes imposed under local laws, and enacted prior to July 1, 1938, must be

assessed before July 1, 1941. As the City has audited and examined only a very small percentage of the returns filed under laws enacted prior to July 1, 1938 the statute will prevent additional assessments after July 1, 1941. Taxpayers will then be free from trouble on all returns filed under the old laws.

Collection of Tax from Purchaser:

The city sometimes sends bills to purchasers who are not charged for the tax, even though the vendor paid the tax, where the invoice does not reflect the tax as a separate item. It is true that on presenting evidence that the tax was paid the assessment will be cancelled, but this is a nuisance to customers which can be avoided if the vendor would always show the tax as a separate item on the bill.

Compensating Use Tax

The practical effect of the decision in the Berwind-White Coal case has been reduced greatly by the enactment of the use tax by the city. Residents of the city and those doing business therein sought to escape the sales tax by making purchases out of the city and even out of the state. There was a personal property tax on merchandise bought outside of the city, but that applied to a limited amount of items, and has not been reenacted. The city instead, following the example of other states, imposed a tax on the use of property bought outside of the city and used within the city. The tax does not apply to property bought in a sale which was subject to the tax, but it does catch all property bought without the payment of the sales tax, so that there is no escape from one tax or the other and residents of the city and concerns doing business therein can gain no advantage by making purchases outside the city. This was probably the goal aimed at.

Everything which would be taxed under the retail sales tax is covered by the law. If a purchase would be exempt from the sales tax, it is exempt from the use tax. Generally speaking (and I really know of no exception) unless a sale would be taxed under the retail sales tax, purchase outside the City is not subject to the use tax. The definitions of terms are identical under both laws.

Vendors maintaining a place of business in the City must collect the use tax or the retail sales tax—it does not matter which. Vendors out of the City may upon application to the comptroller be authorized to collect a use tax at the time of making the sale.

The use tax is better from the City's viewpoint than the old personal property tax. It is not really necessary but was passed between the dates of the decision of the National Cash Register case and the Berwind-White case when the City's right to tax sales in interstate commerce was in doubt.

If a chain store buys merchandise shipped to it in New York but delivered by it to stores without the State, is this a taxable use? This transaction is taxable by law, but by regulation will be exempt.

Compensating use tax does not apply to non-residents.

Gifts are not subject to the compensating use tax.

Gross Receipts Tax

This is a tax on every business whose gross receipts are in excess of $10,000. It is stated to be a privilege tax, imposed for the privilege of carrying on for gain any trade, business or profession within the City of New York.

The tax is at 1/10th of 1% of gross receipts from any trade, business or profession, or 1/5% of the gross income from a financial business, except banks or trust companies. This means that the tax is at

the rate of $1,000. per million dollars of gross receipts of business or $2,000. per million dollars of the gross income of a financial business.

The tax on trades, business, professions, etc. is on the gross receipts, whereas on financial business the tax is on gross income, which is defined to mean all receipts less the cost of the property sold, and less receipts in repayment of loans. In neither case do receipts include receipts from the sale of real estate or from lands.

A financial business has been defined by the comptroller to include stockbrokers, investment trusts, holding companies and commodity brokers and commission merchants where the spread does not exceed 3%.

The tax is a privilege tax for the privilege of carrying on or exercising for gain within the City of New York any trade, business, profession or vocation. The law has not been judicially passed on although similar laws in other states have been approved. We have in this State the situation where a corporation pays a tax to the state for the franchise to do business as a corporation and must nevertheless pay another tax to the City for the franchise of doing business within the City. With the trend of decisions being what it is, it would not surprise me to see this sustained, but on the other hand it would not surprise me to find it upset.

Sales in Interstate Commerce:

The only interesting problem that arises under this law is the extent to which receipts from interstate sales or foreign commerce can be reached.

The local law implies that receipts which cannot be taxed constitutionally are not subject to taxation—which is pretty decent of the common council.

The comptroller is given power by the local law to adopt a method of allocation for receipts which cannot be taxed in the entirety by reason of the Constitution of the United States. Several methods are suggested, but he is given power to adopt any method of allocation calculated to effect a fair and proper allocation, to the end that only that part of the receipt which is properly attributable to the doing of business in the City shall be taxed.

The comptroller has prescribed several allocation formulas. The principal one is as follows:

Three factors are adopted—

(1) a percentage of the value of real and tangible personal property within the City to the total within the United States (averaged at the beginning and end of the year).

(2) wages and salaries—percentage paid in New York to total in the United States.

(3) receipts factor—a peculiar one which I will describe presently.

The three percentages are divided by three, and the average percentage is thus obtained. If the average exceeds 66⅔% it is reduced to 66⅔%. If the average is less than 33⅓% it is increased to 33⅓%, in other words a ceiling of 66⅔ and a floor of 33⅓.

You apply this percentage to receipts from interstate commerce, segregated to the New York place of business and therefore subject to allocation, and put that percentage of such receipts in the tax computation.

The receipts factor however involves a very queer computation and I'm sure you will not understand what I say, I only hope you will believe me. For the computation of the receipts factor only, you go through the following wierd process: You ascertain what relationship the wholly taxable receipts, plus ⅓ of

the allocable receipts on the one hand bear to the wholly taxable receipts and all the allocable receipts on the other hand, and this gives you the percentage of the receipts factor—which is one of three just mentioned.

The draftsman of the regulations must have been intrigued with the number 3—he uses it so many times without rhyme or reason.

To illustrate: If receipts wholly taxable are $20,000. and the receipts from interstate commerce originating out of a New York place of business (the allocable receipts) are $180,000. you have total receipts of $200,000. and all we are trying to do is to ascertain how much of the $180,000. is allocable to New York City. The fraction will be

20 plus (⅓ of 180) that is 80 or
20 plus 180, that is 200,

producing a receipts factor of 40%.

This is added to the other two factors, divided by 3, adjusted as indicated, and the result is the percentage of the interstate sales allocated to New York.

The strange thing is that the more local sales the business has, the higher becomes the percentage of interstate sales allocated to New York City.

The corporation counsel has announced that the formula for allocating receipts from interstate commerce is being contested by the Olive Coat Co. and is on appeal to the Court of Appeals. This case was dismissed on jurisdictional grounds. Must start over again.

There is an alternative formula for New York City manufacturers selling products in interstate commerce, which a manufacturer may use at his option. This formula assumes that the receipts from the sales in interstate commerce are 50% of the cost of manufacturing the goods, and also that the cost of manufacture cannot exceed 66⅔% or be less than 33⅓% of the sales amounts.

For example: If the sales in interstate commerce are $300,000. and the cost of manufacturing is actually $240,000., as this is 80% of the sale the percentage is reduced to 66⅔% of sales or $200,000. 50% of this sum or $100,000. is deemed "receipts from sales in interstate commerce", which is all of the $300,000. received from the sales in interstate commerce that are subject to tax.

In addition to these two formulas, regulations contain methods of allocating receipts from service organizations, bus and trucking companies, receipts from professional services, such as lawyers, accountants and engineers, and finally provide for alternative methods which may be adopted on the initiative of the comptroller or on application of the taxpayer to arrive at any other method which would be more equitable for the taxpayer involved.

These formulas certainly do not make sense. They give the appearance of having been contrived to be so liberal that no one will contest them.

Prior to 1939 receipts from interstate commerce were not taxed at all. The Supreme Court in Adams Manufacturing Co. held that the Indiana gross receipts tax was void for the reason that the tax included in its base without apportionment, receipts from interstate commerce. Some dicta in this opinion, and in the opinion of the Berwind-White case, indicated that the court would sustain a tax if receipts from interstate commerce were apportioned in some fashion. This has never been definitely passed on and probably accounts for the liberality of the regulations.

Pending the decision, however, the tax must be paid under written protest and in any event all the schedules must be filed in order to allow for

the proper application of the allocation formula.

Sales in Foreign Commerce:

Receipts from foreign commerce are not taxed. They must however be included in the return and taken as an allowable deduction. Foreign commerce includes exports and imports to or from a foreign country, and the immunity from tax extends only to receipts from sales of imports only, by the importer in the original unbroken package or container in which they were imported. The exemption does not apply to the sale of imports of liquor, whether or not in the original package,—under a questionable ruling which is being reviewed by the comptroller.

Sales of goods exported to a foreign country are also sales of foreign commerce and similarly free from tax.

These regulations do not give as broad a meaning to foreign commerce as have the decisions of the courts including the Supreme Court.

The general rule is that imports must be co-mingled with the common goods of the country before they may be taxed. The character of goods as articles of interstate commerce is not lost even by processing, let alone by the mere breaking of original containers.

In the Gulf Oil Co. case, affirmed by the U. S. Supreme Court, it was held that crude oil imported from abroad and placed in bonded warehouses in New York City, where it is processed and sold to ships engaged in foreign commerce never loses its character as imports, although refined in this city. The sale of such oil to ships for use in foreign commerce was held not to be subject to the City sales tax. It is not deemed necessary for imported goods to remain in original containers to retain their character as articles of foreign commerce.

So it may be that the comptroller's position that only sales by an importer of imports in original containers are exempt, may not stand up under attack.

Mergers, Etc.

In the case of a merger or a consolidation, or acquisition of a business of another, which was subject to the gross receipts tax, the acquiring corporation or other purchaser shall include as his receipts for gross income the receipts of the acquired concern.

Interest and Dividend Receipts:

There is an open question as to the taxability of interest and dividends under the decision of the Circuit Court of Appeals on July 20, 1940 in Wood Preserving Co. v. Treasurer of Indiana. This case held that interest and dividends are taxable only on an allocated basis where a concern does interstate business.

New York City, however, taxes such receipts in full if the company is doing business at all in New York.

Comparison of Federal and New York State Income Tax Requirements

By Nicholas Salvatore, C.P.A.

A comparison of the more important federal and New York State income tax requirements for individuals, estates and trusts was presented in the January, 1940 issue of The New York Certified Public Accountant. During the past year many important changes in substance and in interpretation affecting such taxpayers were made by the Revenue Act of 1940, the New York State Legislature and by decisions of the United States Supreme Court. These changes are so significant that it was felt desirable to prepare this new article to facilitate the preparation of federal and New York State income tax returns of individuals, estates and trusts for the calendar year 1940 and fiscal years ending in 1941 by setting forth the more important differences and similarities between the federal and New York State income tax laws.

INDIVIDUALS

Subject	Federal	New York State
Who must file returns	Single or married persons not living with husband or wife whose gross income is $800.00 or over.	Single or married persons not living with husband or wife whose net income is $1,000.00 or over or whose gross income is $5,000.00 or over. Net capital gains must be added to net income in determining the liability for filing.
	Married couple living together during the taxable year whose aggregate gross income is $2,000.00 or over.	Married couple living together during the taxable year whose aggregate net income is $2,500.00 or over or whose aggregate gross income is $5,000.00 or over. Net capital gains must be added to net income in determining the liability for filing.
Gross income	Gross income includes, in general, compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law.	Gross income includes, in general, compensation for personal and professional services, business income, interest, rent, dividends, and gains, profits and income derived from any source whatever other than capital gains which are taxed separately and at special rates.
Taxability of salaries	All salaries taxable including those of state and federal employees. Pension awarded by one to whom no services have been rendered is not taxable to recipient.	All salaries taxable including those of federal and state employees, except employees of foreign governments, and under certain conditions pensions paid to officers and employees of the U. S., the state and its subdivisions and agencies.
Dividends	Domestic and foreign dividends subject to normal tax and surtax; domestic dividends paid out of earnings accumulated prior to March 1, 1913 not taxable.	Fully taxable.

Subject	Federal	New York State
Stock dividends	True stock dividends not taxable, stock dividends of different classes or those that change proportionate interests are taxable.	Not taxable.
Dividends paid from depletion reserves	Excluded from gross income and basis of stock adjusted.	Same as federal.
	No distribution can be made from such reserve until all earnings or profits of the corporation accumulated after February 28, 1913 have been first distributed. Reserve determined by reference to basic value of property at March 1, 1913.	No distribution deemed to have been made from such a reserve except to the extent that the amount paid exceeds the surplus and undivided profits of the corporation. Reserve determined by reference to basic value of property at January 1, 1919.
Taxability of interest income	Exempts interest on all state and municipal bonds, partial exemption on federal obligations. Interest on obligations of Home Owners' Loan Corporation subject to surtax only. All other interest taxable.	Exempts interest on all federal obligations, all New York State and local bonds, and on bonds of savings and loan banks of New York and of limited dividend housing companies, organized pursuant to the State Housing Law, also bonds issued by Home Owners' Loan Corporation; taxes interest received on obligations of other states and political subdivisions thereof. All other interest taxable.
Instalment sales	Dealers in personal property on the instalment plan may report as income therefrom in any taxable year that portion of the gross profit realized on such sales measured by the amount of the instalment payments actually received on such sales in that year. In the case of a casual sale or casual disposition of personal property for a price exceeding $1,000.00 or of a sale of real property where the initial payments do not exceed 30% of the sales price, the income may be returned on the instalment basis.	Same as federal.
Losses	Transactions between members of family, partners, controlled corporations, grantors and beneficiaries not allowed.	Bona fide losses allowed.
Wash sales	No deductible loss.	Capital loss may be claimed.
Worthless securities	Worthless corporate securities treated as capital losses.	Same as federal.
Loss on property acquired for personal use	Losses on the sale of personal residence or other property acquired for personal use, not deductible.	Losses on the sale of personal residence or other property acquired for personal use, deductible as a capital loss.

Subject	Federal	New York State
Basis for determining gain or loss on sale of property acquired by purchase	Cost, except where acquired prior to March 1, 1913, in which case basis is cost or March 1, 1913 value, whichever is higher, for computing gain; for computing loss, the basis is cost. No gain or loss recognized if proceeds are between cost and March 1, 1913 value.	Cost, except where acquired prior to January 1, 1919, in which case basis is cost or January 1, 1919 value, whichever is higher for determining gain and whichever is lower for determining loss. No gain or loss recognized if proceeds are between cost and January 1, 1919 value.
Basis for determining gain or loss on sale of property acquired by gift	If acquired after December 31, 1920, basis same as donor's, to determine gain; to determine loss use fair market value at time of gift, if lower than donor's basis. No gain or loss if proceeds are between donor's basis and value at time of gift.	If acquired after December 31, 1927, basis determined same as federal.
	If acquired before 1921, basis is fair market value when acquired.	If acquired before 1928, basis is fair market value when acquired.
Basis for determining gain or loss on sale of property acquired by bequest, devise or inheritance	Basis is value at date of death.	Basis same as federal.
Basis for determining gain or loss on exchanges	Same as in gain or loss on sales provided property received has a "fair market value". No gain or loss arises on (a) exchanges of property in kind held for investment (excepting securities) or for use in trade or business, (b) exchange of common stock for common stock or preferred stock for preferred stock in the same corporation, or (c) exchanges in connection with certain reorganizations.	Same as federal. Non-taxable exchange becomes a taxable one if property is sold within six months of transfer, under certain conditions.
Capital net gains and losses	Long-term capital gains or losses recognized to extent of 66⅔% on assets held 18 to 24 months and 50% on assets held over 24 months. Alternative methods for taxing provided; for net gains taxpayer uses method yielding lesser tax and for net losses, method yielding greater tax.	Capital gains and losses are all of one class, the net capital gains being taxed at one-half the regular rates. Excess capital net losses cannot be used to reduce other income and no carryover to future years is provided. Emergency tax does not apply.
	Gains or losses on assets held less than 18 months known as "short-term capital gains or losses"; 100% of net gain taken into account in computing net income. Short-term net loss not deductible from ordinary income but may be carried forward (in amount not exceeding net income	Excess of personal exemption and credit for dependents over ordinary net income may be applied against net capital gains.

Subject	Federal	New York State
	of year in which incurred), and applied against short-term net gains in succeeding year.	
	Gain or loss on disposition of depreciable assets used in trade or business treated as ordinary income or deduction.	Same as federal.
Deductions from gross income	The items which are deductible from gross income include in general, interest, taxes, losses not compensated for by insurance or otherwise if incurred in the taxpayer's trade or business or incurred in any transaction entered into for profit or arising from fire, storms, etc. or other casualty, or theft, bad debts, depreciation, contributions, depletion, payments by an employer to a pension trust and all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.	Generally, same as for federal except capital losses and capital deductions which are offset against capital gain.
Contributions	Contributions are deductible only if made to organizations within U. S. or its possessions.	Contributions made by a resident deductible even if made to an organization in a foreign country, but organization must be of nature which would be recognized if situated within this country.
	Deductible if made to federal, state or political subdivisions, for exclusively public purposes.	Same as federal.
	Deductible if made to certain U. S. educational, charitable, scientific and general welfare corporations, irrespective of residence of donor (no substantial part of activities should influence legislation).	Same as federal for a resident. In case of a non-resident deductions are restricted to domestic (New York State) organizations.
	Limited to 15% of the net income, per tax return, before deducting contributions.	Limited to 15% of the net income before deducting contributions. No part of capital gains or losses considered in determining the 15% contribution limitation.
	Where the alternative method of computing the capital gain tax applies the 15% limitation is based on the net income including the net long-term capital gain but excluding the net long-term capital loss.	
Interest paid	All interest deductible, except interest paid to purchase or carry tax-exempt securities.	All interest deductible, except when paid on property, income of which is not taxable.

Subject	Federal	New York State
Expenses of co-operative apartment	No deduction by stockholders for carrying charges of corporation.	Interest and taxes paid by corporation deductible by stockholders.
Taxes paid	Federal income taxes not deductible.	Same as federal.
	State income taxes deductible.	State income taxes not deductible.
	Taxes (assessments) on local benefits not deductible.	Similar to federal.
	Real estate taxes deductible.	Deductible unless paid on property, income of which is not subject to tax.
	Estate, inheritance and gift taxes not deductible.	Same as federal.
	Deductions allowed for income and profits taxes paid to foreign countries, unless claimed as credit against tax payable.	Not deductible. (Dividends and/or interest are required to be reported gross.)
	Stock transfer taxes deducted separately as a tax.	Stock transfer taxes on sales or exchanges of "capital assets" deductible only in computing capital gains or losses. Transfer taxes on following kinds of transfers deductible from gross income. On transfer from: 1. Dealer in securities to customer. 2. Executor to residuary legatee. 3. Settlor of trust to trustee. 4. Donor of gift to recipient.
Bad debts	Bad debts or additions to reserve deductible.	Same as federal.
Depreciation, depletion and obsolescence	A reasonable allowance for depreciation, depletion and obsolescence on property used in trade or business may be deducted from gross income.	Same as federal.
	If property was acquired subsequent to March 1, 1913, the basis for computing the deduction is cost.	If property was acquired subsequent to January 1, 1919, the basis for computing the deduction is cost.
	If the property was acquired prior to March 1, 1913, the deduction is computed on the cost or market value at March 1, 1913, whichever is higher.	If the property was acquired prior to January 1, 1919, the deduction is computed on the basis of fair market value on January 1, 1919.
	Discovery value in case of mines—in the case of mines (other than metal, coal, or sulphur mines) discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result	In the case of mines discovered by the taxpayer on or after January 1, 1919, and not acquired as the result of a purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance is based on the fair market value of the property at the date of the dis-

Subject	Federal	New York State
	of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. Depletion allowance based on discovery value limited to 50% of net income (computed without allowance for depletion).	covery or within thirty days thereafter. Limitation on depletion allowance is the same as federal.
	Special formulae used in computing depletion deductions in case of oil and gas wells, coal, metal and sulphur mines.	Generally, the same as federal.
Business expenses	Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.	Business expenses as well as all the ordinary and necessary expenses connected with the production of income required to be included in gross income are deductible.
Net operating loss carryover	Net operating loss for years commencing on and after January 1, 1939 may be carried forward for two years.	No similar provisions.
Personal exemptions	$800.00 for a single person or a married person not living with husband or wife.	$1,000.00 for a single person, or a married person not living with husband or wife.
	$2,000.00 for a husband and wife living together. Exemption may be divided where separate returns filed.	$2,500.00 for a husband and wife living together. Exemption may be divided where separate returns filed.
	$2,000.00 for a head of a family. Credit only allowed where the individual actually supports and maintains in one household one or more individuals related to him by blood, marriage or adoption over whom taxpayer has some moral or legal obligation to exercise family control. Actual support means more than one-half the support. Close relationship by blood applies to the taxpayer's progenitors and lineal descendants. It also applies to his brothers and sisters as well as to uncles, nephews, aunts, and nieces whether related in whole or half blood. Relationship by marriage includes in-laws as well as step-brothers and sisters.	$2,500.00 for a head of a family otherwise the same as federal.
	Where status changes during the year credit must be pro-rated according to number of months in each classification.	Same as federal.
Credit for dependents	$400.00 for each dependent other than husband or wife, under 18 years of age or incapable of self-support because defective.	Same as federal.

Subject	Federal	New York State
	Taxpayer in order to claim the credit must furnish the chief support (more than one-half).	Same as federal.
	The dependent need not (1) be related to the taxpayer, or (2) live with the taxpayer. The taxpayer need not be under any legal or moral obligation to furnish the support.	Same as federal.
	Where status changes during the year credit must be prorated according to number of months in each classification.	Same as federal.
Earned income credit	If net income is $3,000.00 or less, then 10% of net income; if net income is more than $3,000.00 then 10% of net income or earned net income whichever is lower but not less than $300.00 or more than $1,400.00.	No similar provision.
	Earned income from profession—entire amount received as professional fees may be treated as earned income.	No similar provision.
	Individual proprietor or partner—where both personal services and capital are material income producing factors, a reasonable allowance as compensation for personal service actually rendered by the taxpayer, considered as earned income, but the earned income is limited to 20% of the net profits of the trade or business.	No similar provision.
Rates of tax	Normal tax 4% of net income after deducting personal exemption, credit for dependents, interest on obligations of the U. S. and its instrumentalities and earned income credit. Surtax—graduated from 4% to 75% on net income after deducting personal exemption and credit for dependents. (Rates under the Revenue Act of 1940 have been increased over those in prior years for surtax net incomes between $6,000 and $100,000.)	Normal tax: 2% on first $1,000 in excess of personal exemption and credit for dependents. 3% on next $2,000. 4% on next $2,000. 5% on next $2,000. 6% on next $2,000. 7% on excess over $9,000 exclusive of capital gains and losses.
	Recognized net long-term gains included in net income and tax computed at ordinary normal and surtax rates or at a flat rate of 30% if this produces a lower tax.	Net capital gains, after deducting any unused exemption taxable at one-half of the foregoing rates.

Subject	Federal	New York State
	Recognized net long-term losses included in net income and tax computed at ordinary normal and surtax rates or at a flat rate of 30% if this method produces a higher tax.	Emergency tax—1% on net income after deducting personal exemption and credit for dependents and excluding capital gains and losses. Unincorporated business tax—4% of net income from business after deducting exemption.
Defense tax for five years	For any income taxable year beginning after December 31, 1939, and before January 1, 1945 a defense tax of 10% is to be applied to the previously computed normal and surtax before deducting credit for foreign taxes and/or taxes withheld at the source.	No similar provision.
	Defense tax may not exceed 10% of amount by which net income exceeds tax computed without regard to defense tax.	No similar provision.
Credits for taxes against income taxes	Tax paid by debtor corporations on tax-free covenant bonds allowed as a credit against the income tax to bondholders to the extent of 2% of the interest.	No credit allowed.
	Income taxes paid to foreign countries and to U. S. possessions allowed as credits against income taxes due U. S. unless taken as a deduction from gross income.	Income taxes paid by non-resident to state or country of residence allowed as credit when law of jurisdiction grants reciprocal credit.
Returns: *Filing date*	Due 15th day of third month following close of fiscal or calendar year.	Due 15th day of fourth month following close of fiscal or calendar year.
Place of filing	File tax returns with collector of district of legal residence or principal place of business; if none in U. S. with Collector at Baltimore, Maryland.	File at office of New York State Income Tax Bureau, State Office Building, Albany, N. Y. or at any district office of Income Tax Bureau.
	File information returns for salaries, interest, etc., on or before February 15th following calendar year with Commissioner of Internal Revenue, Returns Distribution Section, Washington, D. C.	File information returns for salaries, interest, etc., on or before February 15th following calendar year with State Tax Commission, Income Tax Bureau, Albany, N. Y.
Notarization	Required.	Not required.
Payment of tax	Payable in four quarterly instalments beginning at the time the return is filed.	Normal and net capital gains taxes payable in three instalments, one-half on filing return, one-quarter two months later and one-quarter six months after filing. Emergency tax payable one-half at time of filing return and one-half within two months thereafter.
Non-residents	Same tax rates as residents, if engaged in business or having office in U. S., otherwise special taxes.	Same tax rates as for resident.

Subject	Federal	New York State
	Exemptions and deductions allowed if proper return filed.	Same exemptions as for resident.
	Non-resident aliens having no office or place of business in the U. S. are taxed on income from U. S. sources derived from interest, dividends, rents, salaries, wages, premiums, annuities and compensation, etc. Those whose gross income from U. S. sources is \$24,000.00 or less have 16½% withheld by person making the payment (residents of Canada 5%) and no personal exemptions or credits for dependents may be deducted.	Same tax rates as for resident, but taxed only on income from New York State sources. Income from sources within New York State consists of the taxpayer's entire net income and net capital gain from sources within the State; that is, (a) from all property owned and (b) from every business, trade, profession or occupation carried on within the State of New York.
	Those whose gross income from U. S. sources is more than \$24,000.00 are taxed at the same rate as residents (16½% withheld at source and deducted from normal and surtax—Canada 5%). Personal exemption \$800.00. The \$400.00 credit for dependents allowed to residents of Canada and Mexico only.	Income does not include annuities, interest on bank deposits, interest on bonds, notes or other interest-bearing obligations or dividends from corporations, except to the extent to which the same shall be a part of the taxable income from any business, trade, profession or occupation carried on in this state by the non-resident taxpayer.
	Non-resident aliens having an office in the U. S. are taxed at the same rate as residents except that only \$800.00 personal exemption allowed whether married or single and \$400.00 credit for dependents allowed only to residents of Canada and Mexico.	
	Exemptions and deductions allowed if proper return filed.	Same exemptions as for resident.
Change in residence	No provision similar to State.	Provision for two returns where residence changes during taxable year.
	No similar provision.	Where individual changes his status from that of a resident to that of a non-resident or from that of a non-resident to that of a resident, the return shall be made on the accrual basis.
Change in accounting period	Where return filed for part of year, owing to change in accounting period, income placed on annual basis but personal exemptions allowed for the full year. Tax reduced to proportion that number of months included in return bears to twelve months.	Where return filed for part of year, owing to change in accounting period, (a) the combined net income and capital net gain is placed on an annual basis, (b) personal exemptions allowed for the full year, (c) tax reduced to proportion that number of months included in return bears to twelve months.
Decedents	Accrued income and deductions to be reported for decedent, even if on a cash basis.	Same as federal.

Subject	Federal	New York State
Evasion of sur-taxes by incorporation	Corporations subject to special surtax on undistributed adjusted net income.	No corresponding provisions.
Community income	A husband and wife who are domiciled in a state having community property laws, may each, in filing separate returns, report one-half of the income and one-half of the deductions.	Does not have community property laws. However, a non-resident of New York who is a resident of a state having community property laws must report total income earned in New York State.
Husband and wife	Contributions and capital net gains or losses—husband and wife are treated as a single unit in a joint return.	Same as federal.
	Returns—Where each spouse has net income it may be advantageous to file separate returns. Joint returns advantageous where one spouse has a net loss and the other has net income.	Same as federal.
Partnerships	A partnership does not pay income taxes, but it is required to file a partnership return which shows the net income of the partnership and the distributive shares of the partners, on which they are taxed in their individual returns.	Same as federal.
	Contributions — No deduction for contributions is allowed to a partnership, but each partner is entitled to deduct his proportionate share of such contributions on his individual return.	Same as federal.

ESTATES AND TRUSTS

When return required: Estates	If the gross income of the estate for the taxable year is $800.00 or over.	If the net income of the estate for the taxable year is $1,000.00 or over, or the gross income is $5,000.00 or over. Net capital gains must be added to net income in determining the liability for filing.
Trusts	If the net income of the trust for the taxable year is $100.00 or over, or the gross income is $800.00 or over.	If the combined net income and net capital gain is $1,000.00 or over, or the combined gross income and capital gain for the taxable year is $5,000.00 or over.
Net income	The net income of an estate or trust is computed in the same manner and on the same basis as in the case of an individual with the following exceptions:	Same as federal—also applies to estates.
	(a) Contributions may be unlimited if provided for in will or in deed of trust.	Same as federal.

Subject	Federal	New York State
	(b) A credit is allowed against the net income for amounts distributable to beneficiaries, etc.	Same as federal.
Personal exemption: Estates	Exemption of $800.00 allowed even if in existence for less than 12 months.	Same as federal except exemption of $1,000.00.
Trusts	Exemption of $100.00 allowed even though a trust is in existence for less than 12 months.	Exemption of $1,000.00 allowed even if in existence for less than 12 months.
Rates of tax, payment of tax, filing date and place of filing	Same as set forth under individuals.	Same as set forth under individuals.
Discretionary trusts	Portion of net income distributed to beneficiary, taxable to beneficiary, balance taxable to fiduciary.	All taxable to fiduciary.
Resident and non-resident beneficiaries	A citizen or a resident alien beneficiary of an estate or trust is taxable on his or her share of the net income of such estate or trust.	A resident beneficiary of an estate or trust is taxable on his or her share of the net income of such estate or trust.
	A non-resident alien beneficiary of an estate or trust not engaged in a trade or business within the U. S. and not having an office or place of business therein is taxed on his or her share of the net income of the estate or trust. Returns to be filed and rates of tax vary according to amount of gross income.	A non-resident beneficiary is taxable only on such part of his income from the estate or trust as arises from sources within the State of New York (exclusive of annuities, interest on bank deposits, interest on bonds, notes or other interest-bearing obligations or dividends from corporations, except to the extent to which the same shall be a part of the income from any business, trade or profession or occupation carried on in this state subject to taxation).

GENERAL

Subject	Federal	New York State
Statute of limitations: On additional assessments	3 years after return filed or 5 years after return filed if 25% of gross income omitted from return.	Same as federal.
On refunds	3 years from time return filed or 2 years from time tax paid, whichever period expires later.	2 years from the time of the filing of the return or 1 year from the recomputation of the tax.
		Where an assessment is made on account of deductions disallowed in the year in which they were reported, the Commission may readjust the tax for the years when the deduction should have been taken if within five years of year in which originally reported.

Foreign Trade Accounting

THE papers which follow were presented at a special technical meeting on the evening of May 8, 1940, at the Engineering Auditorium, New York City, under the direction of the Technical Committee on Foreign Trade Accounting. The meeting was opened by Mr. Andrew Stewart, Vice-President of the Society, who in turn introduced Mr. George W. Price, Chairman of the Committee, who presided.

Principles of Foreign Trade Accounting

By MILTON KIRSHENBERG, C.P.A.

There are very few phases of accounting about which so little has been written or which has been so infrequently discussed as foreign trade accounting. Usually, one has little difficulty in finding any number of books, periodicals and articles on such subjects as real estate, municipal, public utility, fiduciary or other specialized branches of accounting. With respect to foreign trade accounting, such is not the case, and only the advent of the present war in Europe has brought this subject to the fore. And yet, with modern business being conducted on an international scale, and with many large domestic corporations having commercial dealings either in or with numerous foreign countries, the importance of this subject becomes apparent. Especially at present, with world trade in a turmoil due to import restrictions, embargoes, stringent currency regulations and declining exchange values, a working knowledge of this subject becomes necessary for every accountant whose clients are engaged in foreign trade, in order that the financial position and results of operations of such business may be properly reflected in its accounts. The subject of foreign trade accounting is no doubt of interest also to other accountants not specifically engaged in this type of work. This paper is presented primarily with the intent to expound some of the basic principles of foreign trade accounting. The application of the principles of foreign trade accounting under present conditions will be presented in another paper this evening.

Foreign trade accounting, in its broad sense, represents the reasons for and the methods of expression of the accounts of one currency in terms of another currency. The conversion of real and nominal accounts represents the method of such expression, whereas the principles of foreign trade accounting determine whether their treatment in the accounts is being properly handled.

The exchange rate is the basis used in expressing the value of one country's currency in the equivalent value stated in terms of the currency of another country. Thus, the unit of French currency is the franc. The current rate of exchange for the French franc in New York is two cents. In order to determine the value of two million francs in dollars, this amount is multiplied by two cents, giving forty thousand dollars. Conversely, it may be stated that French francs are currently quoted in New York at fifty to the dollar, which means that with a given number of dollars there could be acquired fifty times as many francs.

The above is of interest in noting the method of expressing one currency in terms of another, as well as the method of converting foreign assets into equivalent dollar values,

or of dollar values in terms of a foreign currency. For the purpose of this presentation we will consider the necessity of converting foreign currencies into terms of U. S. dollars —(herein referred to as "dollars").

It can be seen that, with regard to conversions, the exchange rate used for purposes of such conversion is of primary importance. There are numerous types of exchange rates quoted in the daily newspapers, and it is important that the proper exchange rate be used. In reading your newspaper you may have come across exchange rates quoted in terms such as "free rate", "nominal rate" and "official rate". A foreign currency may be quoted in terms of one or more of these rates. A "nominal rate" is quoted for countries where there are severe exchange restrictions, and where it is practically impossible to secure remittance of funds. An "official rate" represents the rate of exchange indicated by the government of a country to be the prevailing exchange rate. There are usually two or more exchange rates in force in such country, one for buying foreign exchange, and one or more for selling such exchange. Thus the "official rate" is often the rate at which an exporter of goods sells his foreign exchange to the government in return for local currency. The importer of merchandise purchases this foreign exchange from the government for export purposes at a much higher rate, depending on the type of commodity imported. Thus in Chile the official rate is 19.37 pesos to the dollar, or 5.16c per peso, at which rate the exporter sells his dollars and receives pesos, whereas the importer of necessities must pay for the same exchange 25 pesos to the dollar, or a value of only 4c for the peso. An importer of luxuries must acquire his dollar exchange at 31 pesos to the dollar, or about 3⅓c for the peso. These latter two exchange rates are known as the "free rates" of exchange.

Other countries have similar exchange laws to Chile. In countries like Brazil and Roumania it is usually necessary to pay a premium over the official rate in order to acquire free dollar exchange. A "free rate" is therefore the rate at which foreign exchange can usually be acquired in the open market for transmission to another country, or at which it can be sold in the United States in the event that it is transmitted here in foreign currency. There are, of course, exceptions to these rules.

May I digress for a moment from this paper and indicate another type of "free" and "official" rate than indicated heretofore? At present, in the case of the pound sterling, remittances are being received here at both "free rates of exchange" at a lower dollar value, and at "official rates of exchange" at higher dollar values. Importers of "essential commodities" in Great Britain are at present usually able to sell sterling and purchase dollar exchange at the "official rate", the pound being valued at $4.02, whereas importers of "non-essentials" must acquire dollar exchange in the "free market" and receive, at today's quotations for "free sterling", only $3.31 for the pound.

This rather lengthy discourse on exchange rates has been entered into in order to show the importance of using the correct rate for purposes of conversion. Newspaper rates should not be the sole criterion as to the exchange rates to be used. The correct exchange rate to be used for purposes of conversion is the rate at which the currency was received by a particular company during the most recent period. In some cases this rate may be the same as quoted in the newspapers, while in other instances it may be different. It is possible for the ex-

change rate used by one company at a certain date to be entirely different from the rate that a company in another industry uses for the same currency on the same date. Therefore, each company should use an exchange rate based on its own experience.

In the above paragraphs the words "conversion" or "converting" have been used in connection with the clerical process of changing foreign currency values into U. S. currency values. Some accountants may prefer to use the words "translation" or "translating" or some other expressions instead. I believe, however, that the former expressions are used by the majority of accountants, and they will therefore be used throughout this paper.

This brings us to the matter of accounting for foreign exchange transactions. Foreign business may be conducted by an American concern through the medium of:

(1) The outright sale of merchandise to customers located in foreign nations, or:

(2) The establishment of an agency in a foreign country to handle the sales of products there, or:

(3) The establishment of a branch office of an American company to conduct business in a foreign country, or:

(4) The establishment of a company to do business under the corporate laws of a foreign nation, with the ownership vested in the American company. This type of enterprise is usually known as a foreign subsidiary.

The accounting problems arising as a result of the establishment of the above types of operations vary. (a) There are usually very few foreign trade accounting problems arising under the type of operation outlined under (1) above. If the goods sold by the American company are payable in dollars, then the foreign exchange required to acquire such dollars is provided by the purchaser, who will sustain any resulting exchange loss (or profit). Conversely, if these goods are sold and payable in the currency of the purchaser, the seller acquires payment in foreign exchange, and sustains any loss (or profit) arising from the difference between the dollar invoice value of the goods and the market value of the foreign currency received in payment thereof. (b) If an agency is established in a foreign country (#2 above), and merchandise is shipped there to be sold, with cash being sent from time to time if necessary, then accounts have to be set up on the parent company's books to record this data.

The accounts receivable are usually carried on the parent company's books directly with the customers situated in the foreign country, and all other transactions are recorded on such books. In view of the fact that the merchandise is sold in terms of foreign currency, it is preferable that separate accounts receivable be provided for each customer expressed in foreign currency with its dollar equivalent at the date of sale. Any exchange profit or loss resulting from payment of the accounts may be recorded at the date such payment is received.

In the event of a substantial decline in the book value of the net assets of the agency due to a decrease in the exchange rate of the currency of the country in which the agency is situated, it would be advisable to provide a reserve therefor on the parent company's books.

(c) Conducting business through means of a branch office or a subsidiary of an American company (#3 and #4 above) are two popular methods of doing business abroad. There are a number of reasons why it might be preferable to do business through either one or another of these means, such as tax

costs, business regulations, etc. From an accounting standpoint there is but one major difference between them.

In the case of a branch, the branch profit or loss is usually transferred to the books of the home office at the end of each year, whereas in the case of a subsidiary company profits and losses remain on the subsidiary's books. Profits are only transferred by the subsidiary to the parent company through dividend payments, whereas losses of the subsidiary may, if deemed necessary, be provided for on the parent company's books by reserves against its investment or advances in the subsidiary company. In view of the fact that methods (3) and (4) are the more common mediums of doing business abroad, this paper will devote itself primarily to the accounting aspects thereunder.

In the case of a branch or subsidiary, the home office or the parent company sets up its investment cost at the dollar amount at the date of the investment. The foreign currency equivalent of the dollar investment is set up on the branch or subsidiary's books. Such foreign currency, for purposes of consolidation, is carried at the dollar value appearing on the home office or parent company's books, and does not fluctuate thereafter. At the end of each accounting period, which may be monthly, quarterly, semi-annually or annually, the foreign branch or subsidiary company prepares its trial balance, balance sheet and profit and loss accounts in foreign currency. Such balance sheet and profit and loss accounts are then converted into U. S. currency and consolidated with the balance sheet and profit and loss accounts of the parent company or home office. Such conversion of balance sheet and profit and loss accounts and their consolidation is usually through the medium of working papers at the home office, and is not actually made on its books. The following principles and methods apply to the conversion of real and nominal accounts of the foreign subsidiary or branch office into terms of dollars. In this connection, reference is made to the statement heretofore discussed on the subject of exchange rates to be used for conversion purposes.

Assets

Current. Current assets are converted into dollars at the current "free" rate of exchange prevailing for the foreign currency at the close of business on the date of the balance sheet. In the event that currency is being remitted here at a rate other than the current "free" rate of exchange, then the rate to be used for conversion purposes should be the remittance rate. This is based on the principle that assets such as cash, accounts receivable, etc., should be included in the balance sheet at their realizable values.

Fixed Assets. Such assets as land, buildings, equipment, etc., should be converted at the exchange rate prevailing at the time the assets were acquired. The resulting dollar values should thereafter be used at all balance sheet dates, and should not be changed. Additions to the fixed assets should be converted in the same manner, and the cumulated foreign currency value of the total fixed assets should be carried at the cumulated original dollar converted values.

The foregoing method of arriving at dollar values for fixed assets is based on the accounting principle that surplus should not be affected by the valuing of fixed assets at market prices. This would result were fixed assets converted at current exchange rates at balance sheet dates. Besides, fixed assets are usually necessary for the continued conduct of a business, and should be carried at

a "going concern basis" and not on a "liquidation" basis.

Prepaid Expenses. Such items as prepaid rent, taxes, insurance, etc., are usually considered in the nature of current assets, and as such should be converted at the same rate.

Deferred Charges. If the amount of the deferred charges, such as bond discount and expense, etc., are large in relation to other assets, then it would be proper to convert such items periodically at the exchange rate prevailing at the date that such charges were originally capitalized. If the deferred charges are of a relatively small amount, they may, as a practical matter, be converted at the same rate as current assets.

Deposits. Deposits to secure contracts are usually in the nature of long-term assets rather than current assets, and, if of a substantial amount, should be periodically converted at the same exchange rate as that prevailing at the date of the deposit. However, if the deposits are of relatively minor importance they may, as a practical matter, be converted at the same rate as current assets.

Liabilities

Current. Current liabilities, like current assets, are converted into dollars at the prevailing exchange rate at the date of the balance sheet.

Long-Term. Such liabilities as bonds and mortgages are usually converted for purposes of consolidation at two different exchange rates. That portion due within one year is converted at the exchange rate prevailing at the date of the balance sheet, while that portion due after one year is converted at the exchange rate in effect at the time the obligation was originally incurred.

Reserves

There are different types of reserve accounts, the most common being (1) liability reserves, (2) valuation reserves.

(1) Liability reserves consist of reserves provided for definitely known liabilities of indefinite amounts. The reserve for such liabilities, if due within a year, should be converted at the prevailing closing exchange rates, and, if due after one year, at the rate in effect at the date the liability was incurred.

(2) Valuation reserves consist of reserves provided for such assets as doubtful accounts receivable, or for depreciation of fixed assets. They should be converted into dollars at the same rates of exchange as the rates at which the assets were converted.

The matter of determining the method of converting depreciation expense, and the resulting addition to the depreciation reserve requires some amplification. In view of the fact that the fixed asset for which the depreciation reserve is being provided is converted at the exchange rate prevailing at the time of its acquisition, and is carried at such dollar value during subsequent accounting periods regardless of interim exchange fluctuations, it becomes necessary that the reserve for depreciation should be treated in like manner. That is to say, the depreciation expense for the period and resulting addition to the depreciation reserve should be converted from foreign currency into dollars at the same exchange rate as the asset account.

Capital

The foreign currency value of issued capital stock of a foreign subsidiary or the capital advanced to a foreign branch by its home office is converted at the exchange rate on the day the investment is made. This dollar amount should be in agreement with the dollar value of the investment as shown by the parent company or home office books. For purposes of consolidation, the

dollar equivalent of the foreign currency should, at all times, be kept at its original converted dollar value.

Surplus

The dollar value of the surplus of a foreign company or branch is arbitrarily stated at an amount necessary to bring the balance sheet into balance, and represents the difference between the converted dollar value of the total assets and the converted dollar value of the liabilities and capital. This is of necessity so, inasmuch as the foreign currency value of the asset, liability and capital accounts are converted at different rates of exchange.

The converted dollar value of the surplus account consists of two amounts, namely, (1) the converted dollar value of the foreign currency profits or losses for the period, plus (2) the exchange profit or loss arising from the conversion of assets and liabilities at different exchange rates (due to fluctuation of such rates) at balance sheet dates. Inasmuch as the exchange profit or loss arising under #2 appears only on the conversion balance sheet working papers during consolidation, it is difficult to determine the exact amount of such exchange profit or loss in advance. Therefore, such amount must represent a balancing figure of the surplus account. Of course, once the amount of exchange profit or loss is determined it is possible to check the accuracy of such amount.

The following are the more important sources which give rise to exchange profit or loss:

(1) Exchange profit or loss due to conversion of current assets and liabilities at the present balance sheet date, at a different rate of exchange than at the date of the close of the prior balance sheet.

(2) Exchange profit or loss arising as a result of converting the additions to the reserve for depreciation account during the current period at the rate at which the asset was acquired, rather than the prevailing exchange rate at the date of the balance sheet.

(3) Exchange profit or loss arising as the result of an increase or decrease in the amount of assets or liabilities during the period, which are being converted at other than closing rates of exchange. Such might be the case in the event of partial liquidation of a long-term liability which is being carried at the exchange rate at the time the liability was assumed, but which was liquidated during the present period with current assets being converted at a different exchange rate.

Foreign exchange losses (if any) should be anticipated and provided for either through the conversion of assets and liabilities, as indicated above, or by setting up a reserve for foreign exchange losses, or both. Such losses are usually chargeable directly to operations, although shown separately in the profit and loss account. Under certain conditions they may be charged directly to surplus, provided proper notation to that effect is made in the operating statement. Regarding foreign exchange profits arising as above, it is conservative to follow the accounting principle that losses should be anticipated, but not profits. This may be accomplished by crediting such exchange profits to a reserve for exchange fluctuations. Future exchange losses may be charged thereto. Of course, if the exchange profits are nominal, they may be credited directly to operations.

Profit and Loss Accounts

Profit and loss accounts (with the exception of depreciation expense) are converted by most accountants at the average daily exchange rate during the accounting period, which may be a month, quarter, six months or year. Conversions are made at

the average exchange rate due to the fact that the sales, purchases and expenses are recorded in the profit and loss account, and represent a number of individual daily transactions. With regard to depreciation expense, this item should be converted at the same rate as the asset for which it provides, as outlined under the "Reserves" section.

The foreign currency profit and loss accounts, after being converted into dollars, should be brought into agreement with the profit or loss for the period as disclosed by the converted balance sheet. This may be accomplished by charging an account called "Foreign Exchange Adjustments" with the difference between the net profit or loss, as converted into dollars, and the profit or loss for the period as reflected by the balance sheet.

In conclusion, permit me to state that I have tried to present in this paper a brief summary of the principles of foreign trade accounting. There are no doubt a number of items not covered herein, which, due to the limited time, have of necessity not been included in the presentation of this subject.

Some Considerations Relative to Consolidation of Foreign Accounts

By J. Woodrow Mathews, C.P.A.

ACCOUNTANTS in the United States have recently given a great deal of consideration to questions of converting (or translating) accounts of foreign subsidiary companies and branches, and to the question of proper disclosure of foreign operations in annual reports of domestic corporations. When trade balances among nations were settled in gold and currency systems were stable, the foreign trade problems of today did not exist, and therefore foreign accounting problems were not of great concern to accountants. The accepted methods of converting accounts of foreign subsidiary companies and branches could be found in text books on accounting, and followed without serious concern as to the soundness of the results. At the same time, the question of disclosure of foreign operations was usually met by inclusion of foreign accounts in consolidated financial statements.

The situation today, however, is vastly different. A large proportion of foreign trade is done on a barter basis or under some form of trade agreement, currencies are supported at artificial levels by governments through the use of restrictive measures, and often there are several exchange rates for the same country. Principles followed in dealing with foreign accounts in the past are therefore no longer applicable in full, and it has become necessary for the business world to seek new ways of converting foreign accounts of domestic corporations, and of disclosing foreign operations in annual reports.

Accountants are well aware of this turn of events and have been studying the questions which have arisen. Their most recent statement on this subject is set forth in Accounting Research Bulletin No. 4, issued in December 1939 by the Committee on Accounting Procedure of the American Institute of Accountants. This statement deals with questions of foreign operations and foreign exchange under three main headings, as follows:

1. Treatment of earnings and assets.
2. Consolidation of foreign subsidiaries.

3. Losses and gains on foreign exchange.

With reference to the question of consolidation, the Committee offers four methods of adequate disclosure of information relating to foreign subsidiaries. Briefly, these are:

(a) To exclude foreign subsidiaries from consolidation, and to furnish a summary in suitable form of foreign assets, liabilities, income and losses.

(b) To consolidate and to furnish the summary mentioned under (a).

(c) To furnish complete consolidated accounts, together with consolidated accounts of domestic subsidiaries.

(d) To furnish complete consolidated accounts, together with parent company accounts, showing investments in and income from foreign subsidiaries separately from those of domestic subsidiaries.

Pronouncements on foreign accounting questions have also been made by the Securities and Exchange Commission and the New York Stock Exchange. Views expressed in these pronouncements are in general accord with the views of accountants.

With this background in mind, it is the purpose of this paper to point out some of the factors which should be considered when applying the procedures recommended by the Institute Committee. Before going ahead on this theme, however, it should be observed that while the Committee's statement does not specifically mention foreign branches it seems to be generally understood that branches are intended to be dealt with in the same manner as subsidiary companies. Therefore, as a matter of convenience and of technique, foreign branches should be instructed to set up their accounts as if they were individual enterprises. These branches may then carry unremitted profits accounts on their books, and such profits need not be taken up on the books at head office. In many instances, it may also be advantageous to maintain accounts of foreign companies and branches on a dual currency basis, i.e., to record transactions in local currency and in the currency of the parent company or head office. Measures of this kind should be helpful in providing required factual information.

Turning now to the main question, let us take a company which has to choose one of the methods recommended by the Institute's Committee. If the foreign business is being transacted in countries at war, the decision may be to exclude foreign accounts from consolidation. A decision to exclude might be arrived at on one of several counts: plants are military objectives, profits cannot be remitted, or practical control of the business has been assumed by foreign government agencies. On the other hand, the decision may be to include foreign accounts in the consolidation because plants are not believed to be in jeopardy, exchange restrictions are not yet severe, or the nature of the business is such that consolidation seems to be the fairest way of presenting the accounts.

I think the same conclusions might be reached even though the foreign country were not at war.

Unless conditions are distinctly favorable it is suggested that the hypothetical company exclude foreign accounts from its consolidation, and supplement the annual report with statements or summaries of foreign business expressed in foreign currencies. This treatment should certainly be regarded as a full and fair disclosure, because such statements or summaries would be more informative than dollar figures. In some cases, of course, summaries expressed in dollars may be preferable,

but on the whole the proposal just made is believed to be a sound solution of the problem and in accord with the first method recommended by the Institute's Committee. It also has a practical advantage in that the preparation of summaries in dollars, which involves almost as many problems as complete consolidation, would be obviated.

On first thought it may appear that a summary expressed in foreign currencies would be awkward to prepare, particularly in cases where business is done in a number of different countries. A difficulty of this nature ordinarily may be overcome by preparing a condensed tabulation in which figures are shown to the nearest hundred or thousand units of foreign currency, and by leaving figures of minor companies and branches out of the tabulation. A problem which may be encountered in disclosing the extent of foreign business is the question of what treatment should be accorded profits derived by domestic companies from sales to foreign subsidiaries. This problem will most frequently have to be faced in cases where domestic companies manufacture for their foreign subsidiaries. So far, the attention of accountants has been primarily directed to the disclosure of profits as shown by books of foreign subsidiary companies and branches, but it seems certain that the point here raised is of sufficient importance to warrant careful study.

Continuing with the hypothetical company, if the weight of argument lies in favor of consolidation, it is believed that it would be wise to supplement the annual report with parent company statements and a summary of foreign assets and earnings. This treatment should give a clear view of the foreign stake, and at the same time would emphasize the important differences between parent company and consolidated accounts. With the exception of the summary of foreign assets and earnings, the procedure just suggested is the fourth mentioned in the Institute's bulletin, and seems more desirable than the second or third.

With the view of checking the foregoing conclusions, thirty annual reports for 1939 were briefly reviewed. The review indicated that, regardless of war, twenty-two companies continued to consolidate, five of them making exceptions as to operations in countries seriously affected by warfare, such as Germany, Poland and Austria, etc. The companies which continued to consolidate included summaries of foreign operations in their annual reports and, broadly speaking, may be said to have followed the second procedure recommended by the Institute's Committee. Apparently foreign conditions in 1939 were not unfavorable enough to cause a major swing to exclusion from consolidation. If conditions grow worse in 1940, a pronounced swing to exclusion from consolidation may result.

When a company is faced with conditions which make it undesirable to consolidate, there are various questions to be answered including the following:

At what figure should investments in and advances to foreign subsidiaries be shown in the financial statements?

How should dividends (including transfers of branch profits) remitted in cash by foreign subsidiaries be treated?

As for the first question, the soundest answer seems to be to carry the investments and advances at cost, but provide reserves in cases where losses have occurred or are impending. In cases where consolidation has been the rule in the past, it will of course be necessary to "deconsolidate" in order to achieve the result just stated. (I assume all of you know what is meant by "deconsolidate"). This move would involve

the exclusion of foreign amounts from all consolidated figures, including consolidated surplus.

Under certain conditions, however, it may be desirable to show investments on the basis of underlying net assets, which might result in carrying the investments at an amount greater than cost to the extent of the undistributed surplus of such shares theretofore included in consolidated surplus. Ordinarily, conditions which make it unwise to consolidate would also make it unwise to show investments on a basis other than cost, even though the underlying net assets are greater than cost.

If a basis other than cost is decided upon for the presentation of consolidated accounts, other questions arise as to treatment of the investments on the books of the parent company. For example, good will has been written off in past consolidations. Should it now be written off on the parent company's books? If the underlying tangible assets are greater than cost, should the interest on the parent company's books be written up to the extent of undistributed surplus?

When dividends are received in cash from foreign subsidiaries, accounting conventions would permit them to be reported as income in the year in which received, provided the dividends were paid out of earnings since the dates of acquisition of the foreign subsidiaries. When the dividends are determined to represent a return of investment by virtue of payment from earnings prior to dates of acquisition, or by reason of the liquidation of foreign operations, they should be credited to the investment account. As for dividends which are regarded as income, there is another method of treating them which, in view of the seriously disturbing state of foreign trade today, may be worthy of consideration. This is to carry the dividends to a reserve account pending future determination of the outcome of foreign business.

This alternative and the other suggestions made in this paper are offered for the primary purpose of provoking thought on the questions which confront accountants. In conclusion, it is believed that a conservative procedure should be adopted, because realizations hardly ever come up to expectations.

Disclosure in Published Statements of Foreign Operations

By Alvin R. Jennings, C.P.A.

THE previous speakers this evening have discussed the principles—or as a matter of terminology you may prefer to call them "the accounting conventions"—for disposing of foreign operations in the accounts and the basic factors which underlie decisions as to the most desirable method of displaying the cumulative effect of such transactions in periodical statements. It is the purpose of this paper to treat with the practice, as distinguished from the theory, of displaying the results of foreign operations in periodical statements. In the final analysis, the soundness of any theory can be judged only by the results produced by application of that theory in practice.

You are all aware of the conditions which, in the past six months or so, have tended to make foreign operations and foreign exchange matters of the utmost importance to many enterprises. It is probably no exaggeration to say that the problems incidental to such matters were, in an accounting as well as a business administration sense, the most perplexing which many companies had

to face in the period indicated. In disposing of these problems companies and their independent accountants have no doubt been guided to a material extent by Accounting Research Bulletin No. 4 issued by the American Institute. In an endeavor to determine to what extent the suggestions made in that bulletin were adopted in practice, some fifty-odd annual reports to stockholders were examined. Some of those reports were issued prior to the promulgation of Bulletin No. 4 in December, 1939, but all of them are, for one reason or another, pertinent.

At the outset I should like to make it clear that I do not consider the evidence produced by the review is necessarily indicative of any generally accepted practice. In the first place, the study lacks that which the statistician likes to refer to as "exposure". An accountant, expressing the same thought, would say that the test made was too limited to serve as the basis for tenable conclusions, and I agree. In the second place, without knowledge of the basic facts and conditions which lie back of the selections of the various methods it is, of course, presumptuous to judge the adequacy of the display. Notwithstanding these quantitative and qualitative limitations, it seems appropriate to consider the trend in presentation of information concerning foreign operations as disclosed by the review.

It became evident early in the study that the data did not lend itself to classification and accumulation in such manner that the results could be statistically reported upon. The variety of presentations may have resulted from a variety of conditions, or it may represent individual preference in presentation. Whatever the reason, it was apparent that the review could not be summarized by saying, for example, that of the fifty companies whose reports were examined, so many took up income from foreign operations only to the extent that such income had actually been realized by receipt in dollars, whereas the remaining companies took up the entire income from foreign operations, whether or not realized in dollars within the year. Nevertheless, the review resulted in certain definite impressions regarding methods of handling the several phases of reporting. These impressions follow, arranged in relation to the suggestions which were made in Accounting Research Bulletin No. 4, which, as previously stated, was very likely the standard consulted by those responsible for the financial statements.

Bulletin No. 4 contains seven points. Of these, the first two are in the nature of a preamble, and are not of importance for present purposes. Point number three reads:

"As to earnings, a safe rule for United States companies to follow would be that in their own accounts earnings from foreign operations for the current year should be shown only to the extent that actual remittances for them had been received in the United States. Provision should be made, also, for known losses of subsidiaries. In other words, the position shown should not be made better by the omission of foreign results.

"Any earnings to be reported beyond the amounts already received in the United States should be carefully considered in the light of all the facts. The amounts should be disclosed if they are significant and they should be reserved against to the extent that their realization in dollars may be doubtful."

You will observe that there are really two parts to this suggestion. The majority of companies whose statements were studied apparently concluded that the income from their foreign operations was such that they could safely include in their accounts all such income, whether or

not it was fully realized in dollars. On the other hand, where there was evidence of operations in Poland, Germany or Spain (and sometimes in Italy) the tendency seemed definitely to omit the income from such operations to the extent not remitted to the parent company. Further, in several cases it was noted that the remitted portion of such income was applied by the parent to the reduction of its investment in assets in the countries noted. The general impression gained was that, with the exception of the countries noted, it appeared reasonably probable to those responsible for the financial statements that the income from foreign operations in 1939 could ultimately be realized in dollars.

Point number four suggests that:

"As to assets held abroad, the accounting must take into consideration the fact that most foreign assets stand in some degree of jeopardy, so far as ultimate realization by United States owners is concerned. Furthermore, the possibility of these risks and restrictions being extended must be faced."

This recommendation appears to have been given due consideration. It has already been noted that the income from foreign operations in certain cases was applied to a reduction in the investment in foreign assets. In addition, provision from other sources was disclosed. In some instances the investment was reserved against in full. Perhaps a fair generalization would be, as one might suspect, that while business has abandoned hope of recovering assets in Poland, Germany and in some cases in Spain, it feels that the time has not yet arrived to give up on other foreign investments, more particularly on assets located in France and England.

Point number six suggests possible ways of providing adequate disclosure of information relating to foreign subsidiaries. It is rather lengthy, and since it has been effectively summarized for you by the previous speaker, it need not be repeated here. Essentially it all boils down to how foreign subsidiaries are to be treated in the preparation of consolidated statements. The review of published statements did not disclose any outstanding preference. It did, however, indicate one possibility which was not stated in Bulletin No. 4, that is, consolidation of certain foreign subsidiaries and exclusion of others. This device was employed rather freely in instances where the companies had operations in, let us say, Canada or South America as well as in Europe or where, within Europe, operations were conducted in Poland or Germany as well as in England, France or some other countries where the risk was not deemed to be so great. By and large I would say that the disclosure made, whatever the medium selected, appeared to be satisfactory.

You will note that Method 1 indicated that a summary in suitable form be provided of assets, liabilities, income or losses of foreign subsidiaries. Your attention is directed particularly to the phrase *"suitable form."* A great variety of forms resulted; the amount of detail provided appeared to be in proportion to the apparent importance of the situations. In some instances, where the summary provided was the substantial equivalent of separate statements for foreign interests, it was noted that the data were expressed in the foreign currencies, not in U. S. dollars. It was also interesting to note that while there seemed to be general agreement as to the desirability of giving a rather complete description of the rates used when assets and liabilities were translated into dollars, there was no such degree of consistency in providing information as to the rates used in

translating the result of foreign operations for the period. This perhaps was the result of the fact that the break in exchange occurred in the middle of the year, necessitating, in some cases, the use of one or more rates in respect to operations in a given country. Also, in some instances, the earnings, or a substantial part of them, may have been remitted and converted into dollars at a certain effective rate which was, no doubt, used to translate at least that part of the earnings.

Point number seven treats with the disposition of realized and unrealized foreign exchange gains and losses. It appears to be accepted practice to reflect realized gains or losses in the income account (as opposed to the surplus account). Regarding unrealized losses, it was recommended that:

"Where the corporation's practice is to carry the balance of income to a separate surplus statement, either (1) the provision should appear as a charge in the income statement, the balance before and after the charge perhaps, being shown, or (2) if the amount and the circumstances are such that this would seriously impair the value of the income statement as an indication of earning capacity, and the charge for that reason is made to surplus, a clear disclosure of the treatment should appear in a note in the income statement."

In the majority of the cases reviewed, the charge was made to the income account.

In conclusion, if the conditions abroad remain disturbed for some time, as unfortunately now seems indicated, practice will no doubt further crystalize. In the meantime, the theories of reporting foreign exchange transactions as represented by the recommendations in Accounting Research Bulletin No. 4 appear to be endorsed by practice.

SECURITIES AND EXCHANGE COMMISSION

Accounting Series Release No. 21
February 5, 1941

The Securities and Exchange Commission today announced the adoption of amendments to Rules 2-02 and 3-07 of Regulation S-X, which are designed to correct certain defects disclosed by the Commission's studies of accountant's certificates. Regulation S-X governs the form and content of financial statements required to be filed on Form A-2 under the Securities Act of 1933 and most of the forms promulgated under the Securities Exchange Act of 1934. The amendments become effective March 1, 1941.

At the time of the adoption of Regulations S-X it was stated that "In view of the pending proceedings in the matter of McKesson and Robbins, Incorporated, and several other cases, the rules governing certification by accountants, although altered and clarified in some respects, have been retained in substantially the form now found in the General Rules and Regulations under the Securities Act of 1933 and the several major forms under the 1933 and 1934 Acts. Upon completion of these proceedings, however, such rules are to be considered with a view to revisions deemed necessary as a result of these cases."

The form of the accountant's certificate was considered at some length in the Report of Investigation, in the Matter of McKesson & Robbins, Inc. The following conclusions reached on this subject are quoted from pages 434-435 of the report:*

". . . it appears to us that the following principles should be adopted respecting the form and content of accountants' certificates in order to avoid possibility of confusion in the future.

"The work done should be described as the auditor sees fit and any desired information concerning the accounts may be stated. While we do not think that each audit step should necessarily be set forth, it is to be hoped that really descriptive language will be used as distinguished from a standard form based upon procedures set forth in a bulletin neither of which is referred to in the certificate. While the road is left clear to the auditor to describe in his own language what he has done and what he has found, we suggest one positive requirement in this connection. The certificate should state as part of the description of the scope of examination every generally recognized normal auditing procedure which has been omitted and the reasons for the omission.

"We believe that, in addition to the present expression of opinion that the company's position and results of operations are fairly presented by the accounts, the accountant should certify that the examination conducted was not less than that necessary in order to form the foregoing opinion. This statement may well replace the one generally in use in certificates prior to the present hearings in which the only reference to the examination in the opinion paragraph was in the words 'based upon such examination' or 'subject to the foregoing' following 'In our opinion.' Besides not definitely stating whether the examination was sufficient in scope, these words would seem to incorporate all prior references to the examination in the preceding paragraphs of the certificate and base the auditor's opinion thereupon without specifically stating whether those references were purely descriptive or in the nature of exceptions. Exceptions to the scope of the audit or to the accounts should be expressly so stated in the same sentence as the certification as to the scope of the audit and the opinion as to the accounts, respectively. Exceptions may be incorporated by reference in such sentences but must be specifically designated as 'exceptions.' If any required information has been withheld by the client or access to records denied these facts should, of course, be treated as exceptions.

"We said above that the auditor should certify that the examination was not less than the required minimum of accepted practice both as to procedures and the manner of their application. While accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them, we do think they can and should certify that the examination, on which their opinion as to the financial statements was based, was at least equal to professional requirements."

Amendments of the rules as to accountants' certificates have for some time been the subject of correspondence and discussion between committees representing the American Institute of Accountants, the Controllers Institute of America, and the American Accounting Association, and

* *Copies of the report may be obtained from the Superintendent of Documents, United States Government Printing Office, Washington, D. C., price 60 cents.*

numerous individual accountants and members of the Commission's staff. During this time the suggestions made by individuals as well as by the committees have been given careful consideration and a number of them embodied in drafts of the rules which have been made available to the cooperating committees and individuals for further criticism. Successive revisions and criticism have resulted in the revised rules now adopted by the Commission.

The revised Rule 2-02 sets forth requirements as to the contents of the accountant's certificate and is divided into four sections.

Section (a) states certain technical requirements and involves no change from previously existing rules.

Section (b) contains the requirements for the accountant's representations as to the nature of the audit which he has made. Under subdivision (i) the accountant must give a reasonably comprehensive description of the scope of the audit which he has performed. In accordance with the opinion of the Commission in the McKesson report, the subdivision also requires that, if any generally recognized normal auditing procedures have been omitted with respect to significant items in the financial statements, such omissions shall be stated with a clear explanation of the reasons for such omission. It is contemplated that designation of procedures omitted would be confined to the primary auditing requirements which have been recognized as normal auditing procedure, as for example, the circularization of receivables, and would not extend to detailed or mechanical steps. Since in particular circumstances such omissions may be proper, the specification of such omissions and the reasons therefor in connection with the description of the audit would not be considered as exceptions or qualifications unless specifically so noted in connection with subsection (ii) which requires that the accountant shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. In referring to generally recognized normal auditing procedures the Commission has in mind those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as for example, the various accounting societies and governmental bodies having jurisdiction. In referring to generally accepted auditing standards the Commission has in mind, in addition to the employment of generally recognized normal auditing procedures, their application with professional competence by properly trained persons. The Commission further recognizes that the individual character of each auditing engagement and the facts disclosed through a vigilant, inquisitive, and analytical approach by the auditor may call for the extension of normal procedures or the employment of additional procedures. Therefore, subsection (iii) requires that the accountant also state whether he omitted any procedure deemed necessary by him under the circumstances of the particular case.

Paragraphs two and three of section (b) incorporate provisions of previous rules and add the requirement that "appropriate consideration shall be given to the adequacy of the system of internal check and control," thus emphasizing the importance of this basic element.

Section (c) concerning the opinion of the accountant as to the financial statements covered by the certificate and the accounting principles followed is for the most part a restatement and clarification of previous rules.

Section (d) includes an important change from previous rules, in that it requires in addition to a clear identification of all exceptions that, to the extent practicable, the effect of each exception on the related financial statements be given. A clear explanation of the effect on the financial statements of the use of accounting principles to which exception is taken is deemed necessary if the statements are not to be misleading to investors.

Rule 3-07 incorporates the new requirement that if "any significant retroactive adjustment of the accounts of prior years has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and if the . . . adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."

The text of the Commission's action follows:

Amendment No. 3 to Regulation S-X

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the Securities Act of 1933, particularly Sections 7 and 19 (a) thereof, and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15 (d), and 23 (a) thereof, and finding such action necessary and appropriate in the public interest and for the protection of investors, and necessary for the execution of the functions vested in it by the said Acts, hereby amends Rules 2-02 and 3-07 of Regulation S-X to read as follows:

"RULE 2-02. ACCOUNTANTS' CERTIFICATES

"(a) *Technical requirements*

"The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

"(b) *Representations as to the audit*

"The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

"In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

"Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

"(c) *Opinions to be expressed*

"The accountant's certificate shall state clearly:

"(i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein;

"(ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3-07; and

"(iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

"(d) *Exceptions*

"Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

"RULE 3-07. CHANGES IN ACCOUNTING PRINCIPLES AND PRACTICES

"If any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation."

The foregoing action shall be effective March 1, 1941.

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